In the cases we have just been considering this Court held taxing laws passed by states to be void within the Fourteenth Amendment. They are direct authority that similar laws passed by Congress would be in violation of the Fifth Amendment. Let us take the last case referred to, the case of Gast Realty & Investment Co. v. Schneider Granite Company, 240 U. S. 55. The objectionable feature of the law there considered which made it invalid was that property owners were taxed for street improvements by an arbitrary rule. The arbitrariness consisted in a freakish and irrational method of determining the geographical extent of the property to be taxed. In the present case the arbitrariness consists in a freakish and irrational method of determining the time at which the values are to be fixed as the base for taxation. *For, in effect, the Departmental construction of the excess profits law says in one case 1880 values shall be taken, in the case at bar 1904 values, in another 1912 values and in another 1916 values, and so on.*

If there is any difference between this case and the Gast case, 240 U. S., 55, the law in the present case is the less rational of the two. It produces far greater irregularities. In the Gast case, 240 U. S., 55, the unlucky taxpayer would not be called upon to pay more than four or five times as much as his fortunate neighbor. But in the case now being considered the 1912 value of the claimant's ore lands was fifty times their value in 1904. Yet. other taxpayers whose situations as to the *values*

of their properties and the amounts of their incomes are precisely the same as the claimant's are allowed to use the 1912 values while the claimant is limited to 1904 values.

The law now in question can not be defended as a rough and ready method of approximating values. The discrepancies are too great. In our own case cost is less than 2% of present values. Possibly Congress might have taken an arbitrary date—such as March 1, 1913—as the date upon which invested capital value of *all* corporations should be fixed. But it could not, as the Department seems to think Congress intended to do, fix 1904 as the date for one taxpayer, 1912 for another, and 1916 for another.

(4) The present law as construed by the Department is utterly arbitrary and therefore invalid because the tax depends largely upon the cost of the taxpayer's property so that two taxpayers who have the same income, and property of equal value, will pay wholly different taxes if the cost of the property is different.

If the State of Missouri at the same time it passed the law considered in the Gast case, 240 U. S., 55, had passed an excess profits tax law in terms identical with the one passed by Congress, and that Missouri law had come before the Court to be argued at the same time that the Gast case was argued, could this Court by any possibility have said that the Missouri excess profits tax law

afforded a reasonable basis of classification while the law in the Gast case did not?

Consider the arbitrariness in the present case: The method of computing the tax is complicated but the only thing the taxpayer is concerned with is the amount of the tax finally determined. The net income of this Company for the year 1917, was $12,836,448.58. On this income the Department assessed a tax of $6,220,294.45. This is 48½% of the Company's income for the year. Another company with identical assets and identical business, the only difference being that its ore lands were purchased in 1912 instead of 1902, on the same income would pay a tax of only $5,139,109.84, or 40 per centum of its income. If legislation should select specifically La Belle Company and require it to pay in taxes over $1,000,000 more than its neighbor, precisely alike in all respects, hardly any one would question that that action was the extreme of arbitrariness. Yet, under a complicated mechanism that is what is done under the present law.

In final analysis the question is reduced to this: Is the difference in the *cost* of property enough of a difference to save the tax from the condemnation of utter arbitrariness? For ultimately the tax is made to vary with the cost paid for property.

Although the tax collected is taken out of income, it is measured not by the amount of the income, but by the cost of the property of the corporation as distinguished from income. If the cost of the property of a corporation is high enough

it will pay no excess profits tax at all, although it may have been in receipt in the year 1917 of an enormous income. On the other hand an income small as compared with the other will be taxed heavily if the property of that corporation was bought many years ago when property was cheaper. Therefore the defenders of this legislation must assert that it is reasonable and not arbitrary to make the amount of the income tax depend upon the cost of the property of the corporation. As we have said, to make the amount of the income tax depend upon property at all makes it dubious whether it can be held to be an income tax. But passing that point, is it justifiable to make the amount of the excess profits tax depend not upon the amount of the income but upon the *cost of property?* If the amount of tax is to be varied in any degree by the property of the corporation, it should be varied by present investment value and income producing ability of the property *rather than by its cost.*

It cannot be said that the rate of tax is the same in all cases and that the only inequality is the amount of the deduction allowed; for the final amount of the tax is made to depend on the cost of property. It is just as arbitrary as a law would be which allowed taxpayers living in Missouri to deduct 15% from net income before any excess profits tax is payable while other taxpayers are allowed to deduct only 8%.

In Pollock v. Farmers Loan & Trust Company, 157 U. S. 429, 158 U. S. 601, this Court said that a tax on the income from property was in reality a

tax on the property itself. This is necessarily true, for taxes on property itself must be paid out of its income. Now could a law, passed by a state, be seriously defended if it provided that *a fixed percentage of cost* should be taken as a tax? Would not even those who are most reluctant to invade the discretion of the legislative branch of the Government be forced to admit that such a law was wanting in due process? But except by the most specious of arguments such a supposed law can not be distinguished from the present law.

The final question therefore is: Can a classification based upon cost be defended? How would the Court which decided the Gast case regard a state law which provided for the levy of a tax upon abutting property to pay for a street improvement, the tax based not upon benefits or present values but upon the *cost* of the property? That would surely have been just as obnoxious as the assessment which depended upon the distance to the next parallel street.

It is the established law that in determining the validity of a rate to be charged by a public utility it is entitled to a return upon the fair *value* of its property rather than cost. Willcox v. Consolidated Gas Co., 212 U. S. 19; People v. Jamaica Water Company, 196 N. Y. 39; Cumberland T. & T. Co. v. Louisville, 187 Fed. 637.

We are not unmindful of the extreme caution which this Court will and should exercise in considering a claim that Congress has exceeded its

powers in the enactment of a taxing law. In the first century of the Government apparently the taxing power of Congress was not much brought into question before the Court. In previous cases when this contention has been raised this Court has sustained an excise tax levied on corporations and not on individuals; has sustained an exemption of smaller incomes, and has sustained a progressive rate of tax, the rate increasing on the larger incomes. But in the case now before the Court we have none of these. The exemptions which have been sustained and the progressive tax which has been sustained have been sustained because of a real difference in the situation of the two taxpayers. In the present case we have a Departmental discrimination which is based upon nothing but the date at which the taxpayer acquired his property. We are not saying that the Act is unconstitutional, but that the Department's construction would render it so.

In final analysis the question is one of degree. At one end of the pole all are agreed that the Courts can not be called upon to correct all inequalities and injustices in taxes. At the other end we assume that there will be universal agreement that a wholly arbitrary seizure of property, although under the guise of taxation—such as a tax on all incomes arising west of the Rocky Mountains—will be invalid as confiscation and deprivation of property without due process under the Fifth Amendment. In between these two extremes it must be a question of more or less.

The Court should not dismiss the contentions here advanced by admitting the principle, saying that this case is not of a character coming within the principle, for the Court should seriously inquire as to the application of a principle which it has repeatedly affirmed. If the classification in this case is to be held to be a valid exercise of the power of classification, it must be seriously questioned whether the principle itself—the principle that wholly arbitrary and baseless classification will amount to a violation of the Fifth Amendment—has not been abandoned. How can that principle be regarded as still operative if the classification in this case is held not to contravene it? If any action by Congress is ever to be held arbitrary of what character must it be if this classification is supported? How can the Court say in any subsequent case that there is an ultimate margin not reached by the classification in this case beyond which Congress can not go? Plainly, if two corporations are precisely identical in all respects and the portion of the income to be taxed is arbitrarily fixed, although the rate is the same, it is exactly the same as though there were an arbitrary variation in the *rate* of tax.

But here there *is* also an arbitrary variation in the *rate* of tax, for it must be remembered that invested capital not only determines the deduction or the amount of the income which is free from the excess profits tax, but determines also the *rate* of tax which the *remainder* of the income is to bear.

Thus, a corporation pays 20 per cent of its net income in excess of the deduction and not in excess of *15 per cent of its invested capital,* it pays 25 per cent of its net income in excess of 15 per cent and not in excess of *20 per cent of its invested capital,* and so on at increasing rates up to 60 per cent of its net income in excess of *33 per cent of its invested capital.* With the same income a change in the amount of invested capital may make a much heavier tax.

In Knowlton v. Moore, 178 U. S. 41, the Department had construed the war revenue act of 1898 so as to make the rate of tax to be paid by a legatee depend upon the size of the whole estate. There was much in the Act to lead one to believe that that was what Congress intended. This Court, however, deeming that a construction by which the tax to be paid by a legatee would depend upon the amount of another man's property would make the statute subject to serious doubt as to its validity, ruled that the Department's construction was erroneous and that the law should be construed so as to make the tax depend upon the size of the legacy. It is maintained that the doubt raised in that case by the Department's interpretation of that law was not as great as is created in this case by the interpretation placed by the Department on the law here in question.

The fact that the interpretation put upon the statute by the Department would make it unconstitutional is a most persuasive argument against

the soundness of that interpretation. This leads properly to the conclusion that the arbitrary and baseless classification insisted upon by the Department is not the true construction of the Act.

CONCLUSION.

It is respectfully maintained that the judgment of the Court of Claims sustaining the demurrer and dismissing appellant's petition should be reversed and the case remanded with proper instructions.

Respectfully submitted,

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No. 453

IN THE

Supreme Court of the United States

OCTOBER TERM, 1920.

LA BELLE IRON WORKS, a Corporation,
Appellant,

vs.

THE UNITED STATES,
Appellee.

APPEAL FROM THE COURT OF CLAIMS.

REPLY BRIEF FOR THE APPELLANT.

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PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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APPEAL FROM THE COURT OF CLAIMS.

REPLY BRIEF FOR THE APPELLANT

The Government's brief contains a clear exposition of the general meaning of the Act of October 3, 1917, but the specific contentions advanced in claimant's main brief are not answered.

The first sixteen subdivisions are devoted to the question of what constitutes paid in or earned surplus, within clause (3) of Section 207 (a) of the Act of Oct. 3, 1917. But not only does the brief fail to meet the claimant's argument upon this point generally, but it wholly ignores the point that as applied to a mining enterprise the increase in values created by extensive exploration and de-

velopment work is *earned* in a true sense from any possible point of view.

The seventeenth subdivision of the Government's brief deals to some extent with, but makes no adequate reply to, the claimant's contention that the capitalization in 1912 of the values created by exploration and development work gave the Company the right to include those values in its invested capital within clause (2) of said Section.

In regard to the Government's brief we make two comments of a general nature:

First: The brief is characterized throughout by the assumption that it was the purpose of Congress to limit "invested capital" to what was originally invested by the organizers of the business.

This claim of a broad, comprehensive plan to limit the taxpayer to a fair return on his original investment is not borne out by the Act itself. Thus clause (2) of Section 207 (a) of the Act expressly includes to a certain extent increase in value accruing up to January 1, 1914, where property is paid in for stock. Also if property is exchanged for other property, or is sold for cash, or if a new corporation is organized with precisely the same stockholders, and the same assets, then increase in value is included in invested capital.

Second: The Government fails to understand that in dealing with the construction of the Act two distinct points not connected with

each other were advanced on behalf of the claimant as follows:

(a) That within clause (3) of Section 207 (a) of the Act, increase in value is a part of "paid in or earned surplus and undivided profits". This was elaborated in subdivision I of the claimant's main brief.

(b) That within clause (2) thereof, tangible property was "paid in" in 1912 to the full par value of the stock then issued. This was elaborated in subdivision II of the claimant's main brief.

Practically the entire argument of the Government deals with the question whether increase in value can be included in surplus. But that question concerns only the first of the above contentions. It has nothing to do with the claimant's second point. Of the eighteen subdivisions of the Government's brief, in only one, the seventeenth, is there any reference whatever to subdivision II of the claimant's main brief.

We submit the following short review of the questions involved, following the same order as in our main brief:

I.

The claimant in its main brief contended that, by the correct construction of the Act, the Company is entitled to include as "paid in or earned

surplus and undivided profits," under clause (3) of Section 207 (a), the increase in the value of the ore lands created by development and exploration work and the natural increase in the market price of ore.

In support of this contention the claimant quoted the opinions not only of recognized accountants, but also of distinguished text writers and referred to decisions of the highest courts of various States. The Government's brief makes no mention of these opinions or cases, and cites no cases opposed to those cited by the claimant. The only authorities referred to besides opinions of accountants are two compilations which are no more than explanations of the Departmental regulations.

It is submitted, therefore, that the definition of surplus—that is, the excess of assets at present values over liabilities—given by Morawetz, Machen and Cook, and confirmed by the cases cited in the claimant's main brief, must stand.

On the subject whether the words "paid in or earned" modify the meaning of the word "surplus," the Government's brief admits that if the ore lands had been sold or had been exchanged for other lands the amount received in excess of cost would properly be carried as *earned surplus*. Plainly this is an admission that if increase in value prior to sale is surplus at all (and Morawetz says it *is* surplus) then it is *earned* surplus. For a sale does not create the *earning;* and in this case it should be emphasized that the profit on

these ore lands was earned when the creation of the value by the development and exploration took place. A sale would not have earned the profit.

In fact the Department recognizes constantly as a part of surplus, moneys *earned* but not yet realized. The Department permits a taxpayer to make a return on what is known as an "accrual basis," that is by counting as income for the current year income such as interest *accrued* or *earned* but not *realized* by collection. Any unexpended income (which thus may include moneys only earned and not yet collected) at the end of the year becomes a part of surplus, and is included in invested capital for the following year. In this way "earned surplus" by the recognized practice of the department may include income earned but not yet realized. This shows that the word "earned" is not consistently given the meaning contended for by the Government.

On the point that the surplus in this case was not unearned increment but was created by exploration and development work and was therefore in a true sense earned, it should be remembered that the facts are stated in paragraph VI of the petition and are admitted by the demurrer (R. 4), namely:

> "The said ore lands were acquired by the company prior to the year 1904, the company paying therefor the sum of $190,000. *After the said ore lands were so acquired extensive explorations and development work were car-*

ried on, and it was proved that the said lands contained large bodies of ore, and between the date of the said purchase, as aforesaid, and the year 1912, the said ore lands greatly increased in value. In the year 1912 the actual cash value of the said ore lands which as before stated were acquired prior to the year 1904 for $190,000, was not less than the said sum of $10,105,400, and at all times during the years 1912 to 1917 inclusive, the actual cash value of said ore lands was not less than said sum of $10,105,400."

The Government makes a concession which is a telling point for the claimant. On page 36, in discussing the question whether increase in value prior to sale can be treated as surplus, it is said the appreciation cannot be included at least in assets held "not for resale." A distinction seems therefore to be recognized between a plant, the usefulness of which to a company is not affected by increase in market value, and assets "held for resale." But the assets in question were "held for resale." The ore in the ground was raw material for manufacture.

This point that the assets as to which an increase in value is claimed are held for resale is an important one. Whenever an ordinary enterprise has expended labor and capital on a product intended for resale, resulting in an increase in value, no one would question that the increase in value is *earned.*

The increase in value could properly be carried into inventory and would be carried forward as surplus for the next year. The Department is constantly allowing as a part of invested capital a profit which is based upon corporate activities of that character and which has not yet been realized by sale. But the same thing is equally true of a mining enterprise. The ore is intended for resale and the value is increased by work done—is in a true sense *earned.*

The Government attempts to support its contention that increase in value is excluded from earned surplus by reference to the debates in Congress. Without conceding that debates are properly to be considered for this purpose (Lapina v. Williams, 232 U. S. 78), the court should notice that all that the Government claims is thereby excluded, is *unearned increment;* and the subject of the much-quoted remarks of Senator Simmons was unearned increment. As a matter of fact, the remarks of the Senator, adverted to, were not made at the time of the adoption of the *1917 Act here in question,* but much later, at th etime of the adoption of the *1918 Act,* and so as regards the Act now in question, furnish no possible basis for the Government's argument.

But, that fact aside, the precise question in the case at bar of values created by exploration and development work was not considered, nor debated in Congress at the time. Congress in enacting the law did not use the words "realized by sale" but

did use the word, "earned." The value in the case here was earned and it is included as invested capital. *There is nothing in the act; there is nothing in the regulations; there is nothing in the remarks of Senator Simmons that contradicts this view.*

The Government also stresses the fact that the 1918 law practically reenacted the 1917 law which had already received a practical construction by the Department. But this is to repeat the same error. There was no departmental regulation as to earned surplus which excluded increase in value which was *earned* by development and exploration.

The earning of a surplus is accomplished in a different method by each class or kind of business. A mining enterprise for example has its distinctive features of development and exploration work different from a real estate business, which latter depends in part upon the growth of the community. When mining enterprises have been developed by extensive explorations, and the ore revealed, the value is earned just as much as when a shoe manufacturer puts the manufactured shoes in his warehouse. The value resulting from exploration and development is not an "unearned increment." That term is rather to be applied to real estate where there is an increase in value due perhaps to the growth of the community, or the natural increase of population, and increased ease of transportation, and not at all to activities such as the mine development and exploration we have here.

Mining values are *earned* and *produced* by

mining and engineering skill, the expenditure of money and time in opening up the mine and the employment of labor. We repeat that it is no answer to say that "unearned increment" is not included as invested capital. The value of claimant's property was created and it was against created value that the stock was issued in 1912.

II.

Subdivision II of the claimant's main brief is devoted to the contention that tangible property was paid in for the stock issued in 1912 within clause (2) of Section 207 (a) of the Act, which provides that invested capital shall include among other things:

> "The actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor)."

In 1912, the company amended its charter, which theretofore permitted but one class of stock, so as to provide for both preferred and common. All its shareholders thereupon surrendered their old stock

certificates and received one share of new preferred and one share of new common for each share of old stock. The point made by claimant under subdivision II of its original brief was that this common stock, par value $9,915,400, and preferred stock, par value $9,915,400, a total of $19,830,800, issued in 1912, was fully paid for either by (a) the tangible assets including the ore lands at their increased value or (b) the old stock certificates, tangible property having an actual cash value equal to the par amount of the stock being, thus in either event, "paid in" for stock within said clause (2), and that the Company is accordingly entitled to include the full amount in its invested capital. As stated in our main brief, it is universally held that stock issued under such circumstances is fully paid for; and since this stock was fully paid for, it must have been paid for by the property of the corporation including the ore lands at their increased value, or by the old stock certificates.

Our argument on this point is nowhere specifically taken up and replied to in the Government's brief although it is mentioned in subdivision seventeen. On page 36, it is said:

> "It can scarcely be insisted that it" (the increased value) "was or could have been converted into such earned profits by the mere declaration of a stock dividend in 1912."

On page 37 it is said:

> "Whether, therefore, the values represented by the shares of stock in 1912 can be included in invested capital necessarily depends upon whether the surplus and undivided profits on which they were based were earned surplus and profits which had been employed in the business."

This language entirely misses the point. Under Subdivision II of our main brief, the question discussed is not *the definition of surplus* but whether tangible property was "paid in" for stock in 1912. The Government will concede that if in 1912 La Belle Company had organized a new corporation of the same name and had transferred all the assets to it, the new corporation having the same shareholders owning the stock in the same percentage, the increase in value would be included because the property would be "paid in" at its increased value for the stock of the new company. The ruling in such case would have nothing to do with the definition of surplus. This ruling is found in the opinion of the Solicitor of Internal Revenue, published in Bulletin No. 34-20, page 25:

> "Where a corporation transfers its property to an association composed of its stockholders, and the association after January 1, 1914, but prior to March 3, 1917, transfers substantially the same assets to a new corporation, the fair market value of such assets when transferred to the new corporation should be included in determining the invested capital of the latter. * * *"

The reason why if a new corporation had been formed the increased value of the ore properties would be included in invested capital is that shares which would include the amount of the increase in value would be issued which would be fully paid for by the assets including the ore lands at the increased value.

The law as construed by the Treasury Department permits a newly formed corporation to include the increase in value as part of its invested capital and denies the right to an existing corporation doing business since 1875, to include the demonstrated value of such increase capitalized in 1912. There may be two corporations side by side, with property of equal value, with incomes of the same amount: the one incorporated in 1913, has the right under the Department's ruling to include as invested capital the increase in value for which it issued its stock in 1913; the other organized in 1875 is denied the right to include as invested capital the increase in value for which it issued its stock in 1912. Such is the excess profits law as construed by the Treasury Department. This discrimination imposed on La Belle Company for the single year, 1917, an additional tax of $1,081,184.61. This we claim is an utterly arbitrary tax, based upon the irrelevant circumstance of the date of the incorporation of the company. Such an arbitrary classification is not to be sustained whether the tax is regarded as an excise tax, or as a super-income tax. This appellant, having issued fully paid stock in

1912, against existing values, should not be in a worse position in the application of the tax law than a corporation organized in 1913, which avails itself to the full of what the law permits. Bullen v. Wisconsin, 240 U. S. at page 630.

To the above argument, the general reply of the Government that increase in value is not earned surplus or undivided profits is inapplicable. Apart from the question as to whether mere increase in value is "earned surplus," it is still manifestly true that if tangible property to the full value of stock issued in 1912 was "paid in" therefor, then that stock at its par value is to be included in invested capital.

An examination of the language and purpose of clause (2) Section 207 (a) of the Act, will show that the facts in this case come within it.

Our *first* claim under this clause (2) is simply that the entire stock of $19,830,800 issued in 1912 was fully paid for by the tangible assets including the ore lands at their increased value. This clause (2) does not require that this tangible property paid in for stock must be "earned profits" as suggested by the Government. Nor does its language suggest that the allowance depends upon whether the shares issued in 1912 were based on earned surplus and profits which had been employed in the business. That is a point which arises under clause (3) and not under clause (2).

Clearly the shares issued in 1912 of a par value of $19,830,800 were fully paid for under the au-

thorities cited in claimant's brief which have not been disputed by the Government. The words "paid in" in clause (2) should be construed in the same way that similar words are construed in the ordinary corporation laws of the states. Such laws commonly provide that stock shall not be issued except to the value of money or property paid in to the corporation. The requirements of such laws are satisfied when new stock is issued based upon a reappraisal of assets.

The *second* point made by the claimant under Clause (2) is that the entire new stock of the company, totaling $19,830,800 issued in 1912 was fully paid by the old stock certificates, which were tangible property with an actual cash value equal to that amount. We cannot find that the Government has made any attempt to answer this point, and it cannot be answered, for under the regulations promulgated by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury, cited on page 41 of the claimant's main brief, it is expressly provided that *stocks*, when paid in for stock or shares in a corporation, will be recognized as tangible property so paid in. On this point alone, entirely aside from the other points made in the claimant's brief, there seems to be no question that the judgment of the Court of Claims should be reversed.

III.

The constitutional point raised by the claimant was that the construction placed upon the Act by the Department would create a wholly baseless and arbitrary discrimination, amounting to a deprivation of property without due process of law. The claimant showed that this Court has said that a wholly arbitrary classification in a tax law of Congress would constitute a want of due process.

The present law as construed by the Department is utterly arbitrary and therefore invalid because as applied to two corporations, engaged side by side in the mining business, having the same income and property, the one organized as a new corporation in 1913 has the right to include as invested capital the increase in value against which it issued its stock, while a corporation like the claimant, engaged in business since 1875 is denied the right to include as invested capital the increase in value against which it issued its stock in 1912. In other words, a corporation newly organized is permitted to have a right under the law which is denied to an existing corporation.

The law is arbitrary because the tax also depends largely upon the *cost* of the taxpayer's property, so that two taxpayers who have the same income and property of equal value will pay wholly different taxes if the cost of the property is different.

A decision sustaining the Department's construction in this case would be practically equivalent

to a declaration by this Court that there are no limitations upon Congress' power to make arbitrary exactions in the guise of a tax except the provisions as to uniformity and apportionment. Such a decision would be an abandonment of principles repeatedly enunciated by this Court.

We quote from two of the decisions of this Court on the subject.

In Knowlton v. Moore, 178 U. S. is the following at p. 109:

> " * * * If a case should ever arise, where an arbitrary and confiscatory exaction is imposed bearing the guise of a progressive or any other form of tax, it will be time enough to consider whether the judicial power can afford a remedy by applying inherent and fundamental principles for the protection of the individual, even though there be no express authority in the Constitution to do so."

In Brushaber v. United States, 240 U. S. 1, is the following at p. 24:

> "* * * * And no change in the situation here would arise *even if it be conceded*, as we *think it must be*, that this doctrine would have no application in a case where although there was a seeming exercise of the taxing power, the act complained of was *so arbitrary* as to constrain to the conclusion that it was not the exertion of taxation, *but a confiscation of property;* that is, a taking of the same in violation of the Fifth Amendment; or, what is equiva-

lent thereto, *was so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion.*"

It is the claimant's contention that a law which makes the amount of taxable income and the rate of tax both depend upon so irrelevant a circumstance as the date on which the organization of the corporation took place is so arbitrary as to come within the above language.

The only reference in the Government's brief to this constitutional argument is in subdivision eighteen. The cases cited by the claimant are not mentioned. By way of reply the statement is made that the only uniformity required is geographical uniformity, notwithstanding the following statement on page 47 of the claimant's brief:

> "We shall not raise any point in this argument on the provisions of the Constitution which require uniformity * * * in the levying of certain taxes."

While it is conceded that a wholly arbitrary tax law would be invalid, the law in question is attempted to be defended by the remarkable assertion that *a fair return on the cost of an investment is all anyone expects or is entitled to.*

Would a fair return on $24.00, the price that the Dutch are said to have paid for Manhattan Island be all that a company owning New York City

would expect now to receive. Would one of the original subscribers to Calumet & Hecla Copper Company stock be satisfied with—say, 7%—on his original investment? Would a man who paid $1,000 for a Kansas farm on which an oil strike is made be satisfied with an annual return of—say, $70—while the owner of the adjoining farm is receiving perhaps $1,000,000 annually?

The true meaning of the act is that not only a company incorporated in 1913 has the right to include in its invested capital the value against which its stock was issued, but that such right must be accorded to a corporation existing before that date. The intention of Congress was to treat as invested capital the true value of the tangible property of a corporation against which its stock has been issued.

The construction contended for by the Government would render the act so glaringly unequal and palpably unjust as to make it arbitrary and capricious and thus outside the limits set by the constitution.

Surely this is a case for the application of the language in United States v. Delaware & Hudson Co., 213 U. S. 366 where the Court, in speaking of the rule that where a statute is susceptible to two interpretations by one of which it would be unconstitutional and by the other valid, it is the duty to adopt the latter, went on to say at p. 408 that:

> "The rule plainly must mean that where a statute is susceptible of two constructions, by

one of which grave and doubtful constitutional questions arise, and by the other of which such questions are avoided, our duty is to adopt the latter."

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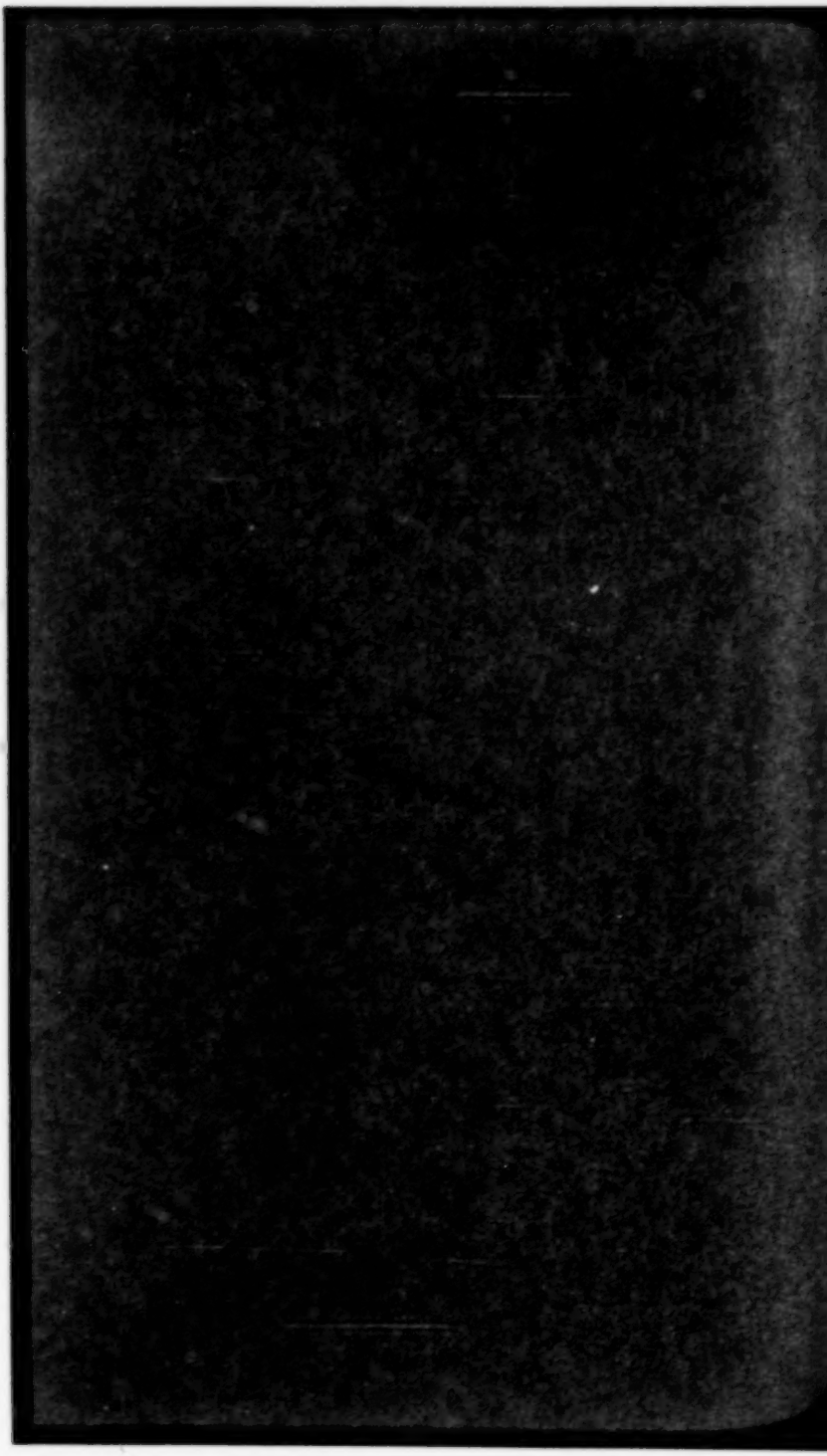

No. 453.

IN THE

Supreme Court of the United States

October Term, 1920.

LA BELLE IRON WORKS, Appellant,
vs.
THE UNITED STATES, Appellee.

APPEAL FROM THE COURT OF CLAIMS.

PETITION OF NATIONAL LUMBER MANUFACTURERS' ASSOCIATION FOR LEAVE TO FILE A BRIEF AND MAKE AN ORAL ARGUMENT, AMICUS CURIAE.

Now comes the National Lumber Manufacturers' Association and moves the Court to grant it leave to file a brief herein and to make an argument *Amicus Curiae*, for the reasons:

1. The reasons for this motion are set out in the suggestions herein incorporated and made a part hereof.

2. Both the Solicitor General and solicitors for appellant have been notified hereof and furnished the proof sheets of the brief which is by the petitioner to be filed herein on the merits. Each of them ~~[recognizes the vast importance to the petitioner of the question to be presented and then]~~ authorize a statement to be made that neither has any objection to the Court making an order that petitioner may as *Amicus Curiae* file a brief and make an oral argument. ~~out of time~~ ~~not these ours~~.

FRANK HAGERMAN,
Solicitor for Petitioner.

SUGGESTIONS IN SUPPORT OF FOREGOING PETITION.

1. The Appeal.

This is an appeal from a judgment of dismissal entered by the Court of Claims upon a demurrer to appellant's petition which sought to recover $1,081,164.61 of taxes wrongfully exacted from and paid under protest by the appellant.

2. The question involved.

The question presented is whether in ascertaining appellant's "invested capital" the taxing officers had the right to exclude therefrom so much of the actual cash value of its land, no matter in what form it existed, as was in fact represented by the increase thereof between the time of its purchase in 1904 and the time the tax was levied in 1917 and was evidenced by the stock dividend of 1912. This question turns on section 207 (40 Stat. L. 306) of the War Excess Profits Act of 1917.

3. Relation of the National Lumber Manufacturers' Associaion (herein called the Association) to this case and the reason for its appearance here amicus curiae.

(a) The National Lumber Manufacturers' Association, herein called the Association, is a voluntary association of the corporate and firm lumber manufacturing companies of the United States. It has a nation-wide membership. Its membership embraces the ownership of the great timber sections of this country along the North Pacific coast and in the entire South. Its members own, in the aggregate, from forty to fifty per cent of the privately owned standing timber and stumpage rights of the entire country. They manufacture practically an equal percentage of the lumber produced in the United States. Each of them employed in business a large amount of "invested capital," such as timber lands, which, since its original organization, had largely appreciated or increased in actual *cash* value over original cost. This appreciation was, as here, sometimes *evidenced* by stock dividends and often carried by book entries of surplus or undivided profits and other designations. Sometimes it was not represented by any distinct or separate entry on the books at all. So when these members came to make returns under the War Excess Profits Act of 1917, they made them on forms which did not *exclude*, but did *include* in "invested capital" the element of "appreciation," or "the increase in value over actual cost." In other words, the law obviously contemplated that upon their "invested capital" they were to be allowed the statutory rate of return; this before they were charged with the War Excess Profits Tax, i. e., a tax of a certain per cent on a

certain part of their income. Therefore, they always contended, and still contend, that, in fairness and justice, their "invested capital" should be construed to be the *actual* fair value of their property, which produced that income. Such is the sole question in this case. This meant the actual cash value of *all* the property appropriated to the business of producing the income which was the very source of the tax. This plain element of cash value was, therefore, in the returns made, taken into consideration. This value, regardless of the *form* which the transaction took, naturally and necessarily included the increment or accretion or increase in value over cost, accruing to the property since its acquisition. For illustration, a tract of timber land bought years ago, by reason of the growth of the trees and the settlement and productiveness of the immediate country, has, just as farming land or city lots have done, largely increased in value. The *natural* increase on account thereof was, in 1917, as much an element of actual value as would exist in the case where a herd of cattle and drove of hogs with their calves and pigs had been bought by a stock raiser at the *then* market price, but the calves and pigs had in time developed into full grown cattle and hogs.

(b) The members of the Association, after conference with the Department of Justice, made their returns for 1917, 1918 and 1919 under the War Excess Profits Act. In each instance each member specifically stated the *amount* of the "appreciation" or "increase in value over cost," in whatever *form* it existed. This was *included* in the computation made of "invested capital." The taxing officers, however, have, so far,

either *neglected* or declined to make assessments for those years on the basis of the *exclusion* of the appreciation element. This *necessarily* implies that the Treasury Department has not *yet* been satisfied that it can or should make an assessment on such a basis. The right to exclude such element is, however, *now* claimed to be justified by the decision below in this particular case. As a result, the Department has now under consideration the question whether it should not take, as a test case, the return of the Weed Lumber Company, one of the members of the Association, and assess a tax by excluding from "invested capital" the entire element of "appreciation," and after so doing then add to the tax thus assessed a penalty for negligence for so making its return. This question of alleged negligence has been recently fully argued and elaborately briefed. It has not yet been decided. All this fully and in detail appears in the record of a cause entitled "In the Matter of Weed Lumber Company," now pending before, but as yet undecided by, the Committee on Appeals and Review of the Internal Revenue Bureau of the Treasury Department.

(c) These members will necessarily be vitally affected by a decision in this case. They have, therefore, a direct and tremendous interest therein, so that the Association, on their behalf, applies for leave of this Court to appear, file a brief and make an oral argument herein as an *amicus curiae*.

Respectfully submitted,

FRANK HAGERMAN,

Solicitor for the National Lumber Manufacturers' Association.

DEC 27 1920
JAMES D. MAHER,
CLERK.

No. 453.

In the

Supreme Court of the United States

October Term, 1920.

LA BELLE IRON WORKS, *Appellant,*

vs.

THE UNITED STATES, *Appellee.*

Appeal from the Court of Claims.

BRIEF OF NATIONAL LUMBER MANUFACTURERS' ASSOCIATION, AMICUS CURIAE.

MASSEY HOLMES,
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I. All doubt as to what is covered by the War Excess Profits Act should be resolved against the government. It should be liberally construed in favor of the taxpayer, so as to assure (a) to him, free of this tax, a part of his income equal to a given percentage on the actual value of the property devoted by him to the production of that income, and (b) to the government, a proportion of all such income from such investment in excess of that percentage. This would necessarily include in "invested capital" the element of "appreciation". . . . 11

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supports that construction. Such "appreciation" was in 1912 actually evidenced by the declaration and payment of a stock dividend in an amount equaling such increase. The effect of the transaction was not to deprive the owner of the "appreciation," but simply to transfer the amount thereof from surplus, of which it was theretofore a part, to capital stock account, where it would thereafter appear..... 43

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LA BELLE IRON WORKS, *Appellant*,

vs.

THE UNITED STATES, *Appellee*.

Appeal from the Court of Claims.

No. 453.

BRIEF OF NATIONAL LUMBER MANUFACTURERS' ASSOCIATION, AMICUS CURIAE.

STATEMENT.

1. Appeal.

This is an appeal (Rec. 14) from a judgment of dismissal entered by the Court of Claims (*id.*) upon a demurrer (Rec. 13) to the plaintiff's petition (Rec. 1-12).

2. The petition to which the demurrer was sustained.

The petition (Rec. 1-12) sought to recover $1,081,164.61 of War Excess Profits taxes wrongfully exacted from and paid under protest by the appellant, a corporation. From this petition it clearly appears that: (a) The tax in question was levied under the Revenue Act of 1917 (40 Stat. L. 300) subjecting the appellant to a tax upon that part of its income in excess of seven per cent upon its "invested capital." (b) Among its assets were certain ore lands, which in 1912, and *at all times thereafter*, had an *actual cash value* of $10,105,400. Appellant, prior to 1904, paid for this land $190,000. Its *actual cash value* so increased that at the time of the assessment and levy of the tax it amounted to $10,105,400. This was an appreciation or increase in actual cash value of $9,915,400 over the actual cost thereof fourteen years before. All of this *increase* was an accomplished fact by 1912. It was *then* actually capitalized by the issue and delivery to the *then* stockholders of a stock dividend of $9,915,400. (c) In computing the amount of the tax, the government officers, however, *excluded* from the "invested capital" the difference between the admitted *actual cash value* of this land in 1912 and 1917, and its actual *cost* of $190,000 paid fourteen years previously, or $9,915,400. This difference was an actual "appreciation" or "increase in value over actual cost," which was shown to exist by extensive explorations and development work and the discovery that the mineral land owned contained

large deposits of valuable ore and it was actually evidenced by the stock dividend.

3. The increase in value was part of appellant's "invested capital."

The increase in value of the tangible property must, on this record, be said to be a part of "invested capital" according to the "known and ordinary signification of language," and "as the words are used in common speech" (Argument, Div. II). That sense is in no wise repelled by the context. Upon the other hand, all doubt on this subject is removed by the fact that the increase in value then a part of invested capital was, in effect, actually paid in "for stock or shares of such corporation" issued as a stock dividend. This transaction, in substance, and regardless of form, simply "transferred" this increase "from surplus to capital." Independently of this thought such increased stock should, in any event, be regarded as stock paid for, to the extent of its value, by "tangible property other than cash." In that case there can be no doubt that it was, according to the Act, part of the "invested capital" (Argument, Div. V). But if there were any doubt as to this and if, as decided below, the stock dividend cannot *technically* be so regarded, still the sense is not repelled by the context, for such increase in value, thus *evidenced* by it, was, in *substance*, and regardless of *form*, part of the "paid in or earned surplus and undivided profits," which, under the very words and within the spirit of the Act, con-

stituted part of such "invested capital" (Argument, Div. VI).

4. The decision below.

The Court of Claims decided that there was neither such "payment" for stock, nor did there exist such "surplus" or "undivided profits." It declined to read the words "invested capital" in their "known and ordinary signification" or as the words are "used in common speech." Upon the other hand, it filed a *per curiam* opinion (Rec. 13, 14) in the form of this memorandum:

> "(1) That the Act in question (40 Stat. 306) undertakes to define 'invested capital' and the averments of the petition cannot be said to bring the plaintiff's case within the definition of section 207.
>
> (2) That the increase in value of plaintiff's ore lands, which was *first declared to be surplus, and afterwards treated as the basis of a stock dividend,* did not thereby become earned surplus or individual (undivided) profits or invested capital within the meaning of the Act of 1917. The stock dividend added nothing to, and took nothing from, the corporation's invested capital.
>
> (3) That the inequalities, which can arise in the application of the statute to particular cases, cannot be corrected by judicial construction, where the enactment is otherwise valid.
>
> (4) That where the Act is ambiguous or uncertain, the construction of it by the administrative officers charged with its execution is entitled to great respect."

Upon this opinion, the demurrer (Rec. 13) was sustained and the case dismissed (Rec. 14). To reverse this action, this appeal (Rec. 14) was taken. It is now presented upon a short record showing the *precise* question involved.

5. The question here.

The question presented is whether in ascertaining appellant's "invested capital" the taxing officers had the right to exclude therefrom so much of the *actual cash value* of its land, no matter in what *form* it existed, as was *in fact* represented by the increase thereof between the time of its purchase in 1904 and the time the tax was levied in 1917, as well as the time when it was evidenced by the stock dividend of 1912.

6. The statute upon which the question involved turns.

(a) This question is a simple one and turns on section 207 (40 Stat. L. 306) of the War Excess Profits Act of 1917, the specific pertinent provisions of which are:

> "As used in this title 'invested capital' * * * means * * *
>
> (a) In the case of a corporation or partnership: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation * * * at the time of such payment * * * and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year * * *."

(b) In its last analysis, the question resolves itself into the inquiry as to whether that part of appellant's actual capital, represented by the admitted increase in *actual cash value* of $9,915,400 and evidenced by the stock dividend of 1912, was a part of its "invested capital." It was plainly such, according to the known and ordinary signification of words. The context of the Act does not repel, but supports, that construction by providing that parts of the "invested capital" are: (1) "The actual cash value of tangible property paid in other than cash for stock or shares in such corporation" (sec. 207, par. [2] of subd. [a]), the capitalization by the stock dividend amounting, in substance, to a paying in of "tangible property other than cash." (2) But in any event, the *actual* cash *value* upon which the stock increase was based was a part of appellant's "paid in or earned surplus and undivided profits" used or employed in the business, exclusive of undivided profits earned during the taxable year" (*id.*, par. [3] of subd. [a]).

7. Relation of the National Lumber Manufacturers' Association (herein called the Association) to this case and the reason for its appearance here amicus curiae.

(a) The National Lumber Manufacturers' Association, herein called the Association, is a voluntary association of the corporate and firm lumber manufacturing companies of the United States. It has a nation-wide membership. Its membership embraces the ownership of the great timber

sections of this country along the North Pacific coast and in the entire South. Its members own, in the aggregate, from forty to fifty per cent of the privately owned standing timber and stumpage rights of the entire country. They manufacture practically an equal percentage of the lumber produced in the United States. Each of them employs in business a large amount of "invested capital," such as timber lands, which, since its original acquisition, has largely appreciated or increased in actual *cash* value over original cost. This appreciation was, as here, sometimes *evidenced* by stock dividends and often carried by book entries of surplus or undivided profits and by other designations. Sometimes it was not represented by any distinct or separate entry on the books at all. So when these members came to make returns under the War Excess Profits Act of 1917, they made them on forms which did not *exclude*, but did *include* in "invested capital" the element of "appreciation," or "the increase in value over actual cost." In other words, the law obviously contemplated that upon their "invested capital" they were to be allowed the statutory rate of return; this before they were charged with the War Excess Profits tax, i. e., a tax of a certain per cent on a certain part of their income. Therefore, they always contended, and still contend, that, in fairness and justice, their "invested capital" should be construed to be the *actual* fair value of their property which produced that income. This meant the actual cash value of *all* the property appropriated to the business of producing the income which

was the very source of the tax. This plain element of cash value was, therefore, in the returns made, taken into consideration. This value, regardless of the *form* which the transaction took, naturally and necessarily included the increment or accretion or increase in value over cost, accruing to the property since its acquisition. For illustration, a tract of timber land bought years ago, by reason of the growth of the trees and the settlement and productiveness of the immediate country, has, just as farming land or city lots have done, largely increased in value. The *natural* increase on account thereof was, in 1917, as much an element of actual value as would exist in the case where a herd of cattle and drove of hogs with their calves and pigs had been bought by a stock raiser at the *then* market price, but the calves and pigs had, in the meantime, developed into full grown cattle and hogs.

(b) The members of the Association, after conference with the Department of Justice, made their returns for 1917, 1918 and 1919 under the War Excess Profits Act. In each instance each member specifically stated the *amount* of the "appreciation" or "increase in value over cost," in whatever *form* it was evidenced, carried or existed. This appreciation was *included* in the computation made of "invested capital." The taxing officers, however, have, so far, either *neglected* or declined to make assessments for those years on the basis of the *exclusion* of the appreciation element. This *necessarily* implies that the Treasury Department has not *yet* been satis-

fied that it can or should make an assessment on such a basis. The right to exclude such element is, however, *now* claimed to be justified by the decision below in this particular case. As a result, the Department has now under consideration the question whether it should not take, as a test case, the return of the Weed Lumber Company, one of the members of the Association, and assess a tax by excluding from "invested capital" the entire element of "appreciation," however evidenced, and after so doing then add to the tax thus assessed a penalty for negligence for so making its return. This question of alleged negligence has been recently fully argued and elaborately briefed. It has not yet been decided. All this fully and in detail appears in the record of a cause entitled "In the Matter of Weed Lumber Company," now pending before, but as yet undecided by, the Committee on Appeals and Review of the Internal Revenue Bureau of the Treasury Department.

(c) These members will necessarily be vitally affected by a decision in this case. They are engaged in an industry peculiarly interested in the question involved, because its very nature requires that there *must* be an increase in value over original cost, if the venture is to prove ultimately profitable. This in order to take care of taxes, carrying charges, losses through storm and fire and expense for protection during the years of the "life of the operation"—usually fifteen to twenty years. This time will necessarily elapse before the owner can realize on all of the large amount of stumpage in which he must originally invest

to justify the expense of installing sawmills, planers, railroads and other equipment essential to the harvesting of the trees and their manufacture into lumber. Increase in value, "appreciation," is deemed indispensable to a profitable "operation." The members of the Association have, therefore, a direct and peculiar interest in this case, so that it, on behalf of its members, has applied for leave of this court to appear herein as an *amicus curiae*. Assuming that such leave will be granted, it files this argument in this cause, and asks that it be received and considered with the same force and effect as if it were directly filed on behalf of appellant.

ARGUMENT.

I.

All doubt as to what is covered by the War Excess Profits Act should be resolved against the government. It should be liberally construed in favor of the taxpayer, so as to assure (a) to him, free of this tax, a part of his income equal to a given percentage on the actual value of the property devoted by him to the production of that income, and (b) to the government, a proportion of all such income from such investment in excess of that percentage. This would necessarily include in "invested capital" the element of "appreciation."

The character of the Act is stamped by the very words describing it, i. e., War Excess Profits tax. That which was deemed a reasonable return from the *investment* was, by Congress, *first* given to the owner. The income *in excess* thereof was deemed, in whole or in part, to result from the war. It was, therefore, declared that a certain percentage of the *excess* income should (in the form of a tax) go to and be paid over to the government. This was upon the theory that he who, *because of the war*, made more in business than was deemed to be a reasonable return, should, for the privilege of making excessive profits during the period thereof, pay a portion of the excess to his government. In construing such an act, fairness

and liberality to the taxpayer should be indulged to the end that justice, not injustice, be done him. As has been remarked (*State* v. *Parker*, 34 N. J. L. 479, 482) of an analogous subject:

> "The policy of the law will be effectuated by bringing within its operation *all* property to which it *can* be applied."

The taxpayer here had "invested capital" of a certain actual cash value. The law should, if possible, be so construed that he is, as a fair return thereon, entitled to receive of the whole income, and keep, *as his own*, seven, eight or nine per cent upon the *actual* value of the investment. It then follows that the *balance* of *that* income from *that* investment can, with reason, be required to be divided between himself and his government. In this way the War Excess Profits tax fairly shares with the public. Otherwise, it cannot fairly so do. The policy and purpose of the law is effectuated by such a construction. There is thereby brought into play that well settled rule of construction which is, in Black on Income and other Federal Taxation (3d Ed) at section 61, thus admirably stated:

> "It is a rule sanctioned by many authorities, and particularly with reference to the revenue laws of the United States, that a *statute imposing taxes is to be construed strictly against the government and in favor of the taxpayer*, and that no person and no property is to be included within its scope unless explicitly placed there by the clear language of the statute, and *no heavier burdens imposed than*

the plain meaning of its terms will warrant. 'It is a general rule, in the interpretation of all statutes levying taxes or duties upon subjects or citizens, not to extend their provisions by implication beyond the clear import of the language used, or to enlarge their operation so as to embrace matters not specifically pointed out, although standing upon a close analogy. In every case, therefore, of doubt, such statutes are construed most strongly against the government and in favor of the subjects or citizens, because burdens are not to be imposed, nor presumed to be imposed, beyond what the statute expressly and clearly imports.' 'If the consideration thus given to the case still leaves the matter in doubt, there should be applied the well settled rule that the citizen is exempt from taxation, unless the same is imposed by clear and unequivocal language and that, *if there is a fair doubt as to the construction of an act imposing taxation, the doubt should be resolved in favor of those upon whom the tax is sought to be laid.*' Applying these principles to the specific case of income taxation, the rule may be deduced that only those persons and corporations are subject to the payment of the income tax who are specifically described in the statute authorizing it or clearly within the meaning of the general terms which it employs, and that *if any substantial and reasonable doubt arises as to whether any particular fund or kind or class of gain or acquisition constitutes taxable 'income' within the meaning of the law, it is to be resolved in favor of the taxpayer and not in favor of the government.* And so the authorities hold. Thus, in regard to the federal corporation tax law of 1909, it was said that this statute, 'levying as it does a tax

upon the citizen, must be strictly construed; it cannot be enlarged by construction to cover matters not clearly within its import. The question is not what congress might have done or should have done, but what it actually did do. When this is ascertained, the duty of the court is accomplished."

The same idea was expressed in *Hartranft* v. *Wiegmann*, 121 U. S. 609, 30 L. Ed. 1012, 1015, by Mr. Justice Blatchford, who there said:

> "We are of opinion that the decision of the Circuit Court was correct. But, if the question were one of doubt, the doubt would be resolved in favor of the importer, 'as duties are never imposed on the citizen upon vague or doubtful interpretations.'"

Upon the same subject, it was in *Eidman* v. *Martinez*, 184 U. S. 578, 583, 46 L. Ed. 697, 701, by Mr. Justice Brown, said:

> "It is an old and familiar rule of the English courts, applicable to all forms of taxation, and particularly special taxes, that the sovereign is bound to express its intention to tax in clear and unambiguous language, and that a liberal construction be given to words of *exception* confining the operation of duty * * *, though the rule regarding *exemptions* from general laws imposing taxes may be different. * * *. We have ourselves had repeated occasion to hold that the customs revenue laws should be liberally interpreted in favor of the importer, and that the intent of Congress to impose or increase a tax upon imports should be expressed in clear and *unambiguous language*."

So, in *Benziger* v. *United States*, 192 U. S. 38, 55, 48 L. Ed. 331, 338, Mr. Justice Peckham said:

> "This provision of the statute should be *liberally* construed in favor of the importer, and if there were any fair doubt as to the true construction of the provision in question, the courts should resolve the doubt in his favor."

In *Gould* v. *Gould*, 245 U. S. 151, 153, 62 L. Ed. 211, 213, Mr. Justice McReynolds recently gave full recognition to the principle by saying:

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen."

In *U. S.* v. *Wigglesworth*, 2 Story, 369, 28 Fed. Cas. 595, 596, 597, No. 16,690, cited with approval in *Gould* v. *Gould*, 245 U. S. 151, 153, 62 L. Ed. 211, 213, it was by Mr. Justice Story, on the circuit, said:

> "In the first place, it is, as I conceive, a general rule in the interpretation of all statutes, levying taxes or duties upon subjects or citizens, not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters, not specifically pointed out, although standing upon a close

> analogy. In every case, therefore, of doubt, such statutes are construed most strongly against the government, and in favor of the subjects or citizens, because burdens are not to be imposed, nor presumed to be imposed, beyond what the statutes expressly and clearly import."

In *Powers* v. *Barney*, 5 Blatchf. 202, 19 Fed. Cas. 234, No. 11361, likewise approvingly cited in *Eidman* v. *Martinez*, 184 U. S. 578, 583, 46 L. Ed. 697, 701, Mr. Justice Nelson, also on the circuit, said:

> "Another principle may also be invoked, which is, that in cases of serious ambiguity in the language of the act, or doubtful classification of articles, the construction is to be in favor of the importer, as duties are never imposed on the citizen upon vague or doubtful interpretations."

II.

No fancied, strained or imaginative rule should be applied so as to construe the words "invested capital," or the words "paid in or earned surplus and undivided profits," as meaning something beyond their "known and ordinary signification" or deal with them other than "as used in common speech," or take them other than "in their natural, straightforward and literal sense."

This necessarily follows from that which Mr. Justice Story at an early date (*Levy* v. *M'Cartee*, 6 Pet. 102, 110, 8 L. Ed. 334, 337) thus aptly said:

> "The Legislature must be presumed to use words in their known and ordinary signification, unless that sense be repelled by the context."

The same line of thought, though in another form, was by Mr. Justice Pitney, in the recent stock dividend case (*Eisner v. Macomber*, 252 U. S. 189, 206, 64 L. Ed. 248, 252, 40 Sup. Ct. Rep. 189, 193) thus advanced:

> "The fundamental relation of 'capital' to 'income' has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purposes, we require only a clear definition of the term 'income,' *as used in common speech*, in order to determine its meaning in the amendment, and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue."

Where the manifest purpose of a statute was, as here, quite plain, the idea was by Mr. Justice Holmes (*U. S. v. Pulaski Co.*, 243 U. S. 97, 107, 61 L. Ed. 617, 621) expressed and enforced by his statement that its meaning was clear "if the words are taken in their *natural, straightforward and literal sense.*"

III.

Congress, since the passage of the Act, has refused to so extend its terms as to require the exclusion from invested capital of the element of "appreciation" or increase in actual cash value over original cost.

(a) This case does not, however, have to rest alone on the "known and ordinary signification" of the words "invested capital" "as they are used in common speech." It really involves more, for in 1919 Congress amended the Act (40 Stat. L. 1057) in some respects. While this amendatory act was pending, the House proposed (H. R. 12863, on a bill introduced Sept. 3, 1918, Cong. Rec. Vol. 56, Part 10, p. 9918, 65th Congress, 2d Session) to adopt, as section 326, an amendment thus defining part of "invested capital":

> "(3) Paid in or earned surplus and undivided profits, not including surplus and undivided profits earned during the taxable year, *and not including the increase in the value of any asset above the original cost until such increase is actually realized by sale.*"

The italicized words constituted the *proposed* amendatory matter. When this bill was reported by the Senate Finance Committee (H. R. 12863, as amended and reported to the Senate on December 6, 1918, Senate Doc. 310), this proposed amendment had been stricken out and the Act as finally passed on February 24, 1919 (40 Stat. L. 1057), does not contain it. Therefore, the element

of "appreciation" was not and has never been intended to be excluded from "invested capital." It has to this day never been *excluded.*

That some effect must be given to the refusal to adopt the amendment is clear from what was, in *Dunlap* v. *United States,* 173 U. S. 65, 75, 43 L. Ed. 616, 619, by Mr. Justice Fuller thus said:

> "* * * it is nevertheless interesting to note that efforts were made in the Senate to amend the bill * * *; that these proposed amendments were rejected."

Therefore, the construction contended for is not only demanded by common sense, justice and fair dealing, but it is one aided by the action of Congress in refusing and failing to make the Act, for the future, read so as to *exclude* from a computation of "invested capital" the element of "appreciation" or "increase in value over original cost."

(b) It is true that Senator Simmons (Sen. Doc. 310), on December 6, 1918, in submitting for the committee the Act of 1918, from which had been eliminated the proposed amendment which would have settled the construction of the exact words used in the *previous* Act of 1917, *erroneously* and *mistakenly* said:

> "Speaking *generally,* assets are valued, for the purpose of determining invested capital, at the price paid in acquiring them *without recognition of subsequent appreciation.*"

The Senator either wholly misunderstood the facts or else he must have had in mind and referred to the construction of the Act of 1917

by the Internal Revenue Department. It must be admitted that he did, indeed, speak very "*generally*" when he said that "assets are valued * * * at the price paid in acquiring them." He would have been more accurate had he said that assets are valued, according to the Treasury Department's construction, *sometimes* at the price paid in acquiring them, and *sometimes* at their actual value at a later date, giving recognition to subsequent appreciation. The Act of 1917 had, in subdivision (a) (2) of section 207, thus expressly provided a *different* basis of value in the case of payment in tangible property for "watered" stock:

> "* * * but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property *as of January first, nineteen hundred and fourteen*, but in no case to exceed the par value of the original stock or shares specifically issued therefor."

This, in such cases, permitted "appreciation" to be included and makes quite clear the inaccuracy of Senator Simmons' statement. So, in Regulations No. 41, relative to the War Excess Profits Tax, it was plainly stated that there were cases in which, contrary to the evidently individual, but erroneous, view of Senator Simmons, allowances were permitted for appreciation. Article 55 thereof provided:

> "Tangible property paid in for stock or shares prior to January 1, 1914, must be valued at either (a) the actual cash value of

> such property on *January 1, 1914,* or (b) the par value of the stock or shares specifically issued therefor, whichever is lower. *This is one of the few cases in which the law permits allowance to be made for appreciation.*"

The Treasury Department itself has, contrary to the construction *implied* in Senator Simmons' erroneous report, permitted assets to be valued at a value greater, *due to appreciation*, than "the price paid in acquiring them," where such assets, respectively the property of two corporations, were transferred to a third corporation, the stock ownership remaining the same. This appears from the Income Tax Rulings Bulletin No. 28-20, p. 17. So appreciation was also allowed in the class of cases instanced by the ruling of the Solicitor of Internal Revenue, appearing in Bulletin No. 34-20, p. 25, the head note of which is:

> "Where a corporation transfers its property to an association *composed of its stockholders*, and the association after January 1, 1914, but prior to March 3, 1917, *transfers substantially the same assets to a new corporation, the fair market value of such assets when transferred to the new corporation* should be included in determining the invested capital of the latter."

But whatever may have been Senator Simmons' understanding or misunderstanding in 1918, of the Act of 1917, *previously* passed, the fact remains that the action of his committee and of Congress itself was a direct refusal to embody in the *new* law the construction which is *now* claimed

should be applied to the *old* one. Clear language, as hereinafter plainly shown (*infra*, Divs. IV, VI), was used by which "appreciation" was included in "invested capital." This being true, the meaning could not be changed by any subsequent misunderstanding of a committee or erroneous view of a senator as to the construction which should be placed upon a *previous* law. The authorities leave no doubt on this subject.

In *United States* v. *Fisher*, 2 Cranch 358, 385, 2 L. Ed. 304, 306, it was so decided by Mr. Chief Justice Marshall saying that where the meaning of the legislature was *plain*, "it must be obeyed."

In *Hadden* v. *Barney*, 5 Wall. 107, 18 L. Ed. 518, 519, 520, Mr. Justice Field said:

> "What is termed the policy of the government with reference to any particular legislation is generally a very uncertain thing, upon which all sorts of opinions, each variant from the other, may be formed by different persons. It is a ground much too unstable upon which to rest the judgment of the court in the interpretation of statutes."

In *Dunn* v. *Reid*, 10 Pet. 524, 527, 9 L. Ed. 519, 520, Mr. Justice McLean said:

> "* * * where the language of the act is explicit, there is great danger in departing from the words used, to give an effect to the law which may be supposed to have been designed by the Legislature. * * * it is not for the court to say, where the language of the statute is clear, that it shall be so construed as to embrace cases, because no good

> reason can be assigned why they were excluded from its provisions."

In *Webster* v. *Luther*, 163 U. S. 331, 41 L. Ed. 179, 182, Mr. Justice Harlan said:

> "But this court has often said that it will not permit the practice of an executive department to defeat the obvious purpose of a statute."

In *United States* v. *Oregon & California R. Co.*, 164 U. S. 526, 41 L. Ed. 541, 545, Mr. Chief Justice Fuller remarked that even

> "The title is no part of an act and cannot enlarge or confer powers, or control the words of the act, *unless* they are doubtful or ambiguous. * * * The ambiguity must be in the context, and not in the title, to render the latter of any avail."

These views were emphatically restated and forcibly applied by Mr. Justice Harlan in *Bate Refrigerating Co.* v. *Sulzberger*, 157 U. S. 1, 37, 39 L. Ed. 601, 611. In *United States* v. *St. Paul, M. & M. R. Co.*, 247 U. S. 310, 313, 62 L. Ed. 1130, 1134, 38 Sup. Ct. Rep. 525, 528, it was said that a report of a legislative committee in charge of a bill could never be received "for the purpose of construing it (the law) *contrary to its plain terms.*" Much less could it be received as a *binding* construction of a previous law which contained language so clear that, considering its real

purpose, there could be no real doubt as to its meaning. Moreover, a committee report should not be accepted as a construction of a *previous* tax law *against* the taxpayer, even if the terms were not as they are, perfectly plain. It is to be remembered that such laws (*supra*, Div. I) are to be construed in favor of the taxpayer. Therefore, the statement of Senator Simmons, even if the report correctly and with a full understanding of the facts stated his views, cannot control the meaning of the *previous* statute.

IV.

The words "invested capital" in their "known and ordinary signification" (Levy v. M'Cartee, 6 Pet. 102, 110, 8 L. Ed. 334, 337), and as "used in common speech" (Eisner v. Macomber, 252 U. S. 189, 206, 64 L. Ed. 248, 252, 40 Sup. Ct. Rep. 189, 192), or if "taken in their natural, straightforward and literal sense" (U. S. v. Pulaski Co., 243 U. S. 97, 107, 61 L. Ed. 617, 621), include "appreciation." Therefore, they should be so construed. This will carry into force the sense and broad purpose of the Act, without regard to any refinement or any attempt to narrowly define particular statutory words.

While the specific question involved is what constitutes "invested capital" under the War Excess Profits Act of 1917, it is quite important to consider the meaning of those words "in their known and ordinary signification" or "as used in common speech." This because (1) it is unlikely that Congress ever intended to use them in a dif-

ferent sense, and (2) before it could be so said, the context of the act must plainly repel such meaning. When the statute attempts to define words, no better approach can be made towards construction than to first take the words in their plain meaning and then judge from the four corners of the act what, if any, change was meant to be made therein. To that end it may be observed:

(a) The words in question are "invested capital." These words, in their plain ordinary sense, have a well defined meaning. An "investment" is (IV Century Dictionary, 3173) said to be:

> "An investing of money or capital; expenditure for profit or future benefit; a placing or conversion of capital in a way intended to secure income or profit from its employment; as, an investment in active business, or in stocks, land or the like; to make safe investment of one's principal. That which is invested; money or *capital laid out for the purpose of producing profit or benefit.*"

In Black's Law Dictionary, 643, the word "invest" is said to mean:

> "To loan money upon securities of a more or less permanent nature, or to place it in business ventures or real estate, *or otherwise lay it out*, so that it may produce a revenue or income."

In IV Century Dictionary and Encyclopedia, 3172, the definition given of the same word is:

> "To employ for some profitable use; convert into some other form of wealth, usually of a more or less permanent nature, as in the

purchase of property or shares, or in loans secured by mortgage, etc.; said of money or capital followed by in; as, to *invest* one's means *in* lands or houses, or *in* bank stock, government bonds, etc.; to *invest* large sums *in* books."

In 28 Cyc. 348 "invest" is thus defined:

> "*To employ for some profitable use;* * * * to place so that it will be safe and yield a profit. * * * literally, to clothe money in some thing; to lay out money in some permanent form so as to produce an income; to lay out (money *or capital*) in business with the view of obtaining an income or profit; to place money so that it will yield a profit."

The word "investment" (*id.* 349) is defined to be:

> "A term which has no technical definition, as applied to money. In common parlance, the term means the putting out of money on interest, either by way of loan or purchase of income-producing property; a form of property viewed as a vehicle in which money may be invested; the loan or putting out of money at interest, so as to produce an income; some species of property from which an income or profit is expected to be derived in the ordinary course of trade or business, as distinguished from speculation."

As the Vice Chancellor in *Una* v. *Dodd*, 39 N. J. Eq. 186, said:

> "So far as I am aware, there is no technical legal definition of the term 'investment.' * * *."

There is, of course, a vital difference between the amount of a given *original* investment and the amount of the *entire* investment. This is made clear by that which was in *Eisner* v. *Macomber*, 252 U. S. 189, 211, 64 L. Ed. 248, 254, 40 Sup Ct. Rep. 189, 195, by Mr. Justice Pitney said:

> "The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his *original* investment, together with whatever *accretions* and *accumulations* have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the *entire* investment."

It is the "capital" which is "invested," and hence it is necessary to ascertain the meaning of the two words. But the word "capital" is of no more doubtful meaning than the word "invested." Black's Law Dictionary, 169, thus defines "capital":

> "The actual estate, whether in money or property, which is owned by an individual or a corporation. In reference to a corporation, it is the aggregate of the sum subscribed and paid in, or secured to be paid in, by the shareholders, *with the addition of all gains or profits realized in the use and investment of those sums*, or, if losses have been incurred, then it is the residue after deducting such losses."

In 9 *Corpus Juris*, 1278, 1279, "capital" is thus defined:

> "As a noun, the sum of money which a merchant, banker, or trader adventures in any undertaking, or which he contributes to the common stock of a partnership; the fund of money or property on which a merchant or voluntary association of persons for conducting a business does business; the fund dedicated to a business to support its credit, to provide for contingencies, to suffer diminution from losses, and *to derive accretion* from gains and profits; that fund which is put up and subjected to the risks of a business as a basis of credit, and as a security to mercantile creditors against loss from the misfortunes of trade; that fund to which creditors look for payment of their claims; *the actual estate, whether in money or property, which is owned by an individual or a corporation.* When used with respect to the property of a corporation or association, it has a settled meaning, and applies only to the property or means contributed by the stockholders as the fund or basis for the business or enterprise for which the corporation or association was formed, the fund on which a corporation transacts business, which is liable to its creditors, and which in case of insolvency passes to a receiver. When applied to corporations the word is sometimes used in the sense of corporate property, and is distinguished from the shares and certificates of stock, which are the individual property of the stockholders, and form no part of the capital of the company; it is generally understood and defined to be the property or means contributed by the stockholders as the fund or

basis for the business or enterprise for which the corporation was formed; the aggregate of the sums subscribed for, and either paid in or agreed to be paid in by the stockholders, with the addition of all gains or profits realized in the use and investment of these sums, or with such diminutions as have resulted from losses incurred in transacting business. When applied to a bank the word includes the *entire* assets, whether represented by the money paid in for the issuance of the stock, surplus, undivided profits, or other property. When used with respect to the property of individuals in any particular business the term has substantially the same import. It then means the property taken from other investments or uses, and set apart for and invested in the special business, and in the *increase*, proceeds, or earnings of which property, beyond the expenditures incurred in its use, consist the *profits* made in the business."

Accumulations, however possessed, produced or acquired, are, as hereinafter demonstrated, "paid in or earned surplus and undivided profits." Whether or not they are evidenced by stock dividends, they are as a matter of fact as much a part of the capital as any of the capital stock or any part of the surplus. The declaration of the stock dividend operated simply as a transfer of the item of "appreciation" from surplus to capital stock account. So it was explicitly decided in *Eisner* v. *Macomber*, 252 U. S. 189, 64 L. Ed. 248, 255, 40 Sup. Ct. Rep. 189. There the government contended that the increased stock distributed to a stockholder as a stock dividend con-

stituted no part of the capital but was a gain or profit. But Mr. Justice Pitney said:

> "* * * there has been no segregation of profits, nor has he any separate certificate representing a personal gain, since the certificates, new and old, are alike in what they represent—a *capital* interest in the entire concerns of the corporation."

In Beach on Private Corporations, at section 466, as quoted and approved in *Tradesman Pub. Co. v. Knoxville Car Wheel Co.*, 95 Tenn. 654, 32 S. W. Rep. 1097, 1102, this distinction is made between capital and capital stock:

> "There is a distinction between the *capital* of a corporation and its capital stock, though they are often used as interchangeable terms. The capital stock is clearly not the same as property possessed by the corporation, for the capital stock remains fixed, although the actual property of the corporation varies in value, and is constantly *increasing* or diminishing in amount. What the amount of the capital shall be is in the discretion of the managers, but the amount of the capital stock is limited and determined by the charter and the laws governing it. It follows, therefore, that the limit imposed upon the capital stock of the corporation does not restrict the amount of property which it may own."

In Morawetz on Corporations, section 791, as likewise quoted and approved in *Tradesman Pub. Co. v. Knoxville Car Wheel Co.*, 95 Tenn. 654, 32 S. W. Rep. 1097, 1102, the same distinction is thus made:

"The capital stock is to be clearly distinguished from the amount of property possessed by the corporation. Occasionally it happens that under the terms of statutes relating to 'taxation', which have been drawn without regard to the technical meaning of words, the courts will construe the capital stock to mean 'all the actual property of the corporation.' But this is for the purpose of carrying out the intent of the statute and is not the real meaning of the terms. At common law the actual stock does not vary, but remains fixed, although the *actual property* of the corporation may fluctuate widely in value, and may be diminished by losses or increased by gains."

The point of distinction thus noted by these great textwriters is elaborated and fully stated and applied by Judge Finch in *People ex rel.* v. *Coleman*, 126 N. Y. 432, 28 N. E. Rep. 818, and by Judge Morton in *Hemingway* v. *Hemingway*, 181 Mass. 406, 63 N. E. Rep. 919.

From the foregoing definitions, the two words "invested capital" "in their known and ordinary signification" (*Levy* v. *M'Cartee*, 6 Pet. 102, 110, 8 L. Ed. 334, 337) or "as used in common speech" (*Eisner* v. *Macomber*, 252 U. S. 189, 206, 64 L. Ed. 248, 252, 40 Sup. Ct. Rep. 189, 193), or, as put by Mr. Justice Holmes (*U. S.* v. *Pulaski Company*, 243 U. S. 97, 106, 61 L. Ed. 617, 621), "in their natural, straightforward and literal sense," would seem to clearly mean the *actual* value of *all* the assets, whether (*infra*, subd. [d]) represented by stock (original or increased) or carried as a surplus, or as undivided profits or

under some other name, or not carried on the books at all.

(b) The very definition of the word "appreciate" (I Century Dict. & Ency. 277) is:

> "To raise in value; advance the exchange, quotation, or price of; opposed to depreciate."

This implies that it is an element of *actual* value and it, therefore, must be considered as part of "invested capital."

(c) But one need not rest on implication as to this for the books leave no doubt on the subject. Thus, in *Gray* v. *Darlington*, 15 Wall. 63, 21 L. Ed. 45, 46, the question involved was whether such increase was part of the capital. Mr. Justice Field said:

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. *Mere advance in value in no sense constitutes the gains, profits or income specified by the statute. It constitutes and can be treated merely as increase of capital.*"

This conclusive language was in *Lynch* v. *Turrish*, 247 U. S. 221, 230, 231, 62 L. Ed. 1087, 1093, 1094, not only quoted with approval, but Mr. Justice Pitney said of the case from which the quotation was taken:

> "Indeed the case decides that *such advance in value is* not income at all, but merely *increase of capital*, and not subject to a tax as income."

Bailey v. *Clark*, 21 Wall. 284, 22 L. Ed. 651, 652, involved the construction of an act levying a tax upon the *capital* of a bank, in adopting which, Mr. Justice Field, among other things, significantly said:

> "When used with respect to the *property* of a corporation or association, the term has a settled meaning; it applies only to the property or means contributed by the stockholders as the fund or basis for the business or enterprise for which the corporation or association was formed. * * * And, when used with respect to the property of individuals in any particular business, the term has substantially the same import; it then *means the property taken from other investments or uses and set apart for and invested in the special business*, and *in the increase*, proceeds or earnings of which property, beyond expenditures incurred in its use, consist the *profits* made in the business."

This language is in Black's Law Dictionary, 169, adopted as one of the definitions of the word "capital."

Coming still closer to this case, it may be observed that *Eisner* v. *Macomber*, 252 U. S. 189, 208, 211, 64 L. Ed. 248, 253, 254, 40 Sup. Ct. Rep. 189, 193, 194, decided that the stock coming as the result of a stock dividend, was *capital*. Upon this subject, Mr. Justice Pitney said:

> "Certainly the interest of the stockholder is a *capital* interest and his certificates of stock are but the evidence of it. * * * A 'stock dividend' shows that the company's

> *accumulated profits* have been *capitalized*, instead of distributed to the stockholders or *retained as surplus* available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been *transferred from surplus to capital*, and no longer is available for actual distribution."

If, therefore, such a dividend may be declared and paid for by existing "appreciation," as is recognized by all the books (infra, Div. V), manifestly the stock issued on the strength thereof becomes part of the *capital*. This must be so since the very power to declare a stock dividend rests upon the thought that the assets, upon account of which it is declared, already exist as *surplus* and by the declaration are transferred *to capital stock* account.

In *Leather Mfrs.' Nat. Bank* v. *Treat*, 62 C. C. A. 644, 128 Fed. Rep. 262, 263, the principle was plainly stated that

> "* * * when a statute as this does, levies a tax upon the capital used or employed by bankers generally, firms and individuals, as well as corporations, the meaning is to tax *all* the money and assets invested in the business as the basis of profits (*Bailey* v. *Clark*, 21 Wall. 284, 22 L. Ed. 651), not only the original investment, but also the *additions* and *accretions*. *Mutual Insurance Co.* v. *Supervisors of Erie*, 4 N. Y. 442; *People* v. *New York*, 23 N. Y. 219; *Wetherbee* v. *Baker*, 35 N. J. Eq. 501; *Tradesmen's Pub. Co.* v.

Car Wheel Co., 95 Tenn. 654, 32 S. W. 1097, 31 L. R. A. 593, 49 Am. St. Rep. 943; *Hannibal R. Co.* v. *Shacklett*, 30 Mo. 558; *Martin* v. *Zellerbach*, 38 Cal. 300, 99 Am. Dec. 365; *Security Co.* v. *Hartford*, 61 Conn. 89, 23 Atl. 699."

The stock dividend actually declared and vigorously upheld in the great case of *Williams* v. *Western Union Telegraph Co.*, 93 N. Y. 162, was for such an increase in value of the corporate assets. Numerous cases are cited in 2 Cook on Corporations (7th Ed.), section 536, to sustain this statement of the text as to the right to declare a stock dividend out of accretions:

> "It is also made when the corporate plant has *increased in value*, and it seems better to issue new stock to represent the excess in value than to sell the increase and declare a cash dividend. In this country these dividends are *frequently* made, and are sustained by the courts."

In *Doyle* v. *Mitchell*, 247 U. S. 179, 187, 62 L. Ed. 1054, 1060, Mr. Justice Pitney said:

> "When the act took effect plaintiff's timber lands, *with whatever value they then possessed, were a part of its capital value* * * *."

The same thought was advanced in *Lynch* v. *Hornby*, 247 U. S. 339, 344, 62 L. Ed. 1149, 1151, where Mr. Justice Pitney said:

> "Dividends are the appropriate fruit of stock ownership, are commonly reckoned as income, and are expended as such by the stockholder without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or *are based upon the increased value of the property of the corporation.*"

The foregoing definitions and decisions lead to the irresistible conclusion that "appreciation" or "increase in value over cost" is, *unless necessarily excluded by the plain language of the statute*, an element of "invested capital." As by Mr. Justice Pitney in *Southern Pacific R. Co.* v. *Lowe*, 247 U. S. 330, 339, 62 L. Ed. 1142, 1147, said:

> "* * * we are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, as being capital, not income, for the purposes of the act. And we perceive no adequate ground for a distinction, in this regard, between an accumulation of surplus earnings and the *increment due to an appreciation in value of the assets of the taxpayer.*"

In several recent cases this same doctrine has been recognized and enforced (*Tozone* v. *Eisner*, 245 U. S. 418, 62 L. Ed. 372; *Lynch* v. *Turrish*, 247 U. S. 221, 62 L. Ed. 1087; *Lynch* v. *Hornby*, 247 U. S. 339, 62 L. Ed. 1149) by direct holdings that such increases in value are part of capital assets. Reference may also be well here made to the able and exhaustive opinions of Judge Denison

in *Doyle* v. *Mitchell*, 149 C. C. A. 106, 235 Fed. Rep. 686, affirmed here (247 U. S. 179, 62 L. Ed. 1054), and Judge Sanborn in *Lynch* v. *Turrish*, 149 C. C. A. 649, 236 Fed. Rep. 653, likewise affirmed here (247 U. S. 221, 62 L. Ed. 1087). These furnish unanswerable reasons, based upon authority, why appreciation should be considered as part of invested capital. This regardless of the form in which it might exist.

(d) The plain purpose of the Act was to permit a person, out of the income from his actual investment, to take and keep as his own a certain percentage *on the value* thereof. This was deemed to be a reasonable return thereon. It is, therefore, a natural and certainly a fair conclusion that this return must be computed on the actual value of the *entire* investment. This would necessarily include any *distinct* and *perceptible* appreciation or increase of value over the original cost. It would include the value of the existing stock, whether in the form originally issued on the formation of the corporation or subsequently issued as a stock dividend. It would, in fact, include "the entire assets as represented by the money paid in from the issuance of the stock, surplus, undivided profits or other property" (9 Corpus Juris, 279). In plain words, "invested capital" means the actual value of the entire property. When that value *exists in fact*, it is wholly immaterial how it may have been acquired or may be held or how, for business convenience, it may be subdivided. Common sense so teaches. Justice and fair dealing so require. Words in their "known and

ordinary signification," and "as used in common speech" so imply. The real question here is whether the *entire* capital shall be permitted to include the increase, not in what particular form this element of increase may or should be carried. It may be represented in or by the original or increased stock, or by surplus or undivided profits, or be carried in any other name. It need not be entered on the books at all. The question is whether it is a perceptible, distinct and constituent element of the entire investment. Such is the clear result of the authorities. Thus in 14 Corpus Juris, 803, it is said:

> "And it makes no difference whether such surplus assets have been carried on the books as surplus, or as segregated assets, or in a special fund account, or otherwise."

In *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 189, 62 L. Ed. 1054, 1060, 38 Sup. Ct. Rep. 467, 470, Mr. Justice Pitney thus stated the principle:

> "Nor is the result altered by the mere fact that the *increment of value* had not been entered upon the plaintiff's books of account. Such books are no more than evidential, being neither indispensable nor conclusive. The decision must rest upon the actual facts, which, in the present case, are not in dispute."

In *Gulf Corporation* v. *Lewellyn*, 248 U. S. 71, 72, 62 L. Ed. 133, 134, Mr. Justice Holmes so recognized when he said:

> "The petitioner was a holding company owning all the stock in the other corporations

concerned except the qualifying shares held by directors. These companies, with others, constituted a single enterprise, carried on by the petitioner, of producing, buying, transporting, refining, and selling oil. The subsidiary companies had retained their earnings, although making some loans inter se, and all their funds were invested in properties or actually required to carry on the business, so that the debtor companies had no money available to pay their debts. In January, 1913, the petitioner decided to take over the previously accumulated earnings and surplus, and did so in that year by votes of the companies that it controlled. But, *disregarding the forms gone through*, the result was merely that the petitioner became the holder of the debts previously due from one of its companies to another. It was no richer than before, but its property now was represented by stock in and debts due from its subsidiaries, whereas formerly it was represented by the stock alone, the change being effected by entries upon the respective companies' books. * * * It is true that the petitioner and its subsidiaries were distinct beings in contemplation of law, but the facts that they were related as parts of one enterprise, all owned by the petitioner, that the debts were all enterprise debts due to the members, and that the dividends represented earnings that had been made in former years, and that practically had been converted into capital, unite to convince us that the *transaction should be regarded as bookkeeping* rather than as 'dividends declared and paid in the ordinary course by a corporation.' "

The principle was decided in *Eisner* v. *Macomber*, 252 U. S. 189, 210, 211, 64 L. Ed. 248, 254, 40 Sup. Ct. Rep. 189, 194, in upholding a *stock* dividend as capital. Describing the book entries following the transaction, Mr. Justice Pitney said:

> "This, however, is merely bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities; it affects only the *form*, not the essence * * * Having regard to the very truth of the matter, to substance, and not to form, he has received nothing that answers the definition of income within the meaning of the 16th Amendment."

In *Bassett* v. *U. S. Cast Iron Pipe & Foundry Co.*, 74 N. J. Eq. 668, 70 Atl. Rep. 929, 932, it was said:

> "This fund never became actual working capital. It was never actually employed in the business in which the company was engaged. It has always remained in cash or securities. *It has always been a mere creature of bookkeeping, and, although as a matter of account merely, it was set apart and tagged with a new name, its physical condition and character were never changed.* * * * *I fail to see how its character as 'Surplus Net Profits' can be changed by calling it 'Reserve for Additional Working* Capital', and doing nothing more about it. If the fund is of this nature and character, then it is under the full control of the directors, and may be used by them for the payment of the dividend in question. They may diminish it for lawful purposes and in a lawful manner in their discretion. They may open other accounts with

> other names on their books, and appropriate the whole or any part of it thereto; but, whatever they do about it, so long as it is not actually paid out, it must remain in fact 'Surplus Net Profits'. *Mere bookkeeping entries cannot affect* it."

This case was affirmed on appeal (*75* N. J. Eq. *539, 73* Atl. Rep. *514*), and its doctrine afterwards applied in *Hyams* v. *Old Dominion Copper Mining etc. Co., 82* N. J. Eq. *507, 89* Atl. Rep. *37, 40*, where it was said:

> "But it makes no difference whether it is carried as surplus or as segregated assets, or in a special fund account, or otherwise. It is money which belongs to the corporation and is under the control of its directors, and it is subject to distribution among the stockholders if the directors see fit to make distribution of it."

The same case was, on appeal, affirmed (*83* N. J. Eq. *705, 92* Atl. Rep. *588*), and when the fund was called "segregated assets" instead of "surplus" or "undivided profits," the court in affirming the decision below, that the name was not material, said:

> "The question is whether the financial standing of the company justified the dividend."

These views, as already observed (*supra*, subd. c) have been elaborately and forcefully expressed on the circuit by Judge Denison in *Doyle* v. *Mitchell*, 149 C. C. A. 106, 235 Fed. Rep. 686

here (247 U. S. 179, 62 L. Ed. 1054) affirmed, and by Judge Sanborn in *Lynch* v. *Turrish*, 149 C. C. A. 649, 236 Fed. Rep. 653, also here (247 U. S. 221, 62 L. Ed. 1087) affirmed. This branch of the argument should not be passed by without rereading the thorough opinions of these learned judges, which have heretofore been here approved.

(c) In view of the *liberality* of construction in favor of the taxpayer (*supra*, Div. I), the necessity of construing words in their "known and ordinary signification" (*id.* Div. II), and a desire to reach the real purpose of the law, the words "invested capital," "as used in common speech" (*id.*), should be held to *include* and not to *exclude* the element of "appreciation." This is surely true, unless the context of the Act is such that it *necessarily* excludes it. When clearly understood it has no tendency to do so.

V.

The context does not require the words "invested capital" to be used other than in their "known and ordinary signification" or other than "as used in common speech," or taken other than "in their natural, straightforward and literal sense." These words do, in fact, include "appreciation" or "increase of value over actual cost." The context, instead of repelling, really supports that construction. Such "appreciation" was in 1912 actually evidenced by the declaration and payment of a stock dividend in an amount equaling such increase. The effect of the transaction was not to deprive the owner of the "appreciation," but simply to transfer the amount thereof from surplus, of which it was theretofore a part, to capital stock account, where it would thereafter appear.

(a) The statute, in express terms, provides that besides the actual cash paid in, "invested capital shall include the actual cash *value* of tangible property *paid in other than cash* for stock or shares in" the appellant corporation.

(b) The appellant's *original* stock was paid in. This was in 1912 lawfully increased by a *stock* dividend then duly declared and paid by the delivery of *shares* of stock to the stockholders. This stock dividend was made to represent and was treated as paid by the "appreciation" or "increase in value over the original stock," which was "in other than cash," i. e., by that which was in fact part of the surplus (infra, Div. VI). The increase in value was evidenced by vesting it in the

stockholders in the form of *shares* of stock. The effect thereof was (*Gibson v. Mercantile*, 252 U. S. 189, 211, 64 L. Ed. 248, 254, 40 Sup. Ct. Rep. 189, 194) simply to transfer the appreciation from surplus to capital stock account. Therefore, in the broadest sense actual tangible property was "paid in other than cash for stock or shares." The validity and propriety of such a dividend has been generally recognized as shown in 1 Cook on Corporations (7th Ed.), at section 287, where it is said:

> "A frequent method of issuing an increase to the capital stock is by stock dividend: * * * but in all cases of a stock dividend as a method of issuing an increase of the capital stock, there must be in possession of the corporation an amount of property over and above its corporate debts equal to the whole capital stock, including the increase, and this amount cannot afterwards be used for any kind of a dividend."

In 2 Cook on Corporations (7th Ed.) 530 it is also said:

> "A stock dividend, as the name imports, is a dividend of the stock of the corporation. Such a dividend is lawful when an amount of money or property equivalent in value to the full par value of the stock distributed as a dividend has been *accumulated and is permanently added to the capital stock of the corporation.* Corporations frequently make a dividend of this character when improvements of the corporate property or extensions of the business have been made out of the

profits earned. It is also made when the corporate plant *has increased in value*, and it seems better to issue new stock to represent the *excess* value than to sell the increase and declare a cash dividend. In this country these dividends are frequently made, and are sustained by the courts."

(c) In *Williams* v. *Western Union Telegraph Co.*, 93 N. Y. 162, 188, 189, it was decided upon elaborate reasoning, that the increase in value of corporate assets may, as was the case here, be distributed as stock. Judge Earl, among other things, said:

"By loss or misfortune, or misconduct of the managing officers of a corporation, its capital stock may be reduced below the amount limited by its charter; but *whatever* property it has up to that limit must be regarded as its capital stock. *When its property exceeds that limit, then the excess is surplus.* Such surplus belongs to the corporation and is a portion of its property, and, in a general sense, may be regarded as a portion of its capital, *but in a strictly legal sense it is not a portion of its capital, and is always regarded as surplus profits.* The very section we are considering contemplates that there may be a surplus, and that such surplus may be divided. The surplus may be in cash, and then it may be divided in cash; it may be in property, and if the property is so situated that a division thereof among the stockholders is practicable, a dividend in property may be declared, and that may be distributed among stockholders. All *such* dividends diminish and deplete the property of the corporation, and that section was

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designed to prevent dividends of property which tended to deplete the assets of the company of its capital stock. But stock dividends never diminish or interfere with the property of a corporation, and hence are not within the purview of that section. After a stock dividend a corporation has just as much property as it had before. It is just as solvent and just as capable of meeting all demands upon it. After such a dividend the aggregate of the stockholders own no more interest in the corporation than before. The whole number of shares before the stock dividend represented the whole property of the corporation, and after the dividend they represent that and no more. A stock dividend does not distribute the property, but simply dilutes the shares as they existed before. * * *."

The principle of this case has, as shown by the cases in 2 Cook on Corporations, 7th Ed., sec. 536, note 2, been generally adopted, was here long since recognized (*Gibbons* v. *Mahon*, 136 U. S. 549, 34 L. Ed. 525; *Logan Co.* v. *United States*, 169 U. S. 253, 42 L. Ed. 737) and several times has recently received distinct approval (*Towne* v. *Eisner*, 245 U. S. 418, 62 L. Ed. 372; *Lynch* v. *Hornby*, 247 U. S. 339, 62 L. Ed. 1149, 1151; *Peabody* v. *Eisner*, 247 U. S. 347, 62 L. Ed. 1152; *Gulf Oil Corporation* v. *Lewellyn*, 248 U. S. 71, 63 L. Ed. 133). It has still more recently, in the stock dividend case (*Eisner* v. *Macomber*, 252 U. S. 189, 208, 209, 211, 64 L. Ed. 248, 253, 254, 40 Sup. Ct. Rep. 189, 193, 194), after the fullest discussion and reconsideration, been enlarged upon, applied and enforced to the broadest

extent. That case distinctly decides that the sole effect of the stock dividend, as applied to the facts of this case, was not to extinguish or to cast aside the element of "appreciation," but simply transfer it from the surplus to capital stock account. So broad is the principle asserted in the latter case that its reasoning settles every question here involved, Mr. Justice Pitney, among other things, saying:

> "Thus the surplus may increase until it equals or even exceeds the par value of the outstanding capital stock. This may be adjusted on the books in the mode adopted in the case at bar by declaring a 'stock dividend.' This, however, is no more than a book adjustment, in essence not a dividend but rather the opposite; no part of the assets of the company is separated from the common fund, nothing distributed except paper certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution. In order to make the adjustment, a charge is made against surplus account with corresponding credit to the capital stock account, equal to the proposed 'dividend'; the new stock is issued against this and the certificates delivered to the existing stockholders in proportion to their previous holdings. This, however, is mere bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities; it affects only the form, not the essence of the "liability" acknowledged by the corporation to its own

shareholders, and this through a readjustment of accounts on one side of the balance sheet only, increasing 'capital stock' at the expense of 'surplus'; it does not alter the pre-existing proportionate interest of any stockholder, or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of shares, with consequent dilution of the value of each share. A 'stock dividend' shows that the company's accumulated profits have been *capitalized*, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholders, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to *capital*, and no longer is available for actual distribution. The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance, and not to form, he has received nothing that answers the definition of income within the meaning of the 16th Amendment."

In *Williams* v. *Western Union Telegraph Co.*, 93 N. Y. 162, 190, it was decided that the legal effect of a stock dividend was the same as if property had been by the stockholder turned over to the corporation and new stock for its value had been issued therefor. Judge Earl said:

> "But here it is found that over and above its capital it possessed property actually worth upwards of $15,000,000, and we know of no law that is violated, and no public policy that is invaded by issuing to the stockholders stock to represent that amount of property rather than in any mode to divide it up and distribute it among them. If it can issue stock in payment of property to be obtained by it as part of its capital for its legitimate uses, why may it not issue stock to its stockholders in payment for property in effect purchased of them and added to its permanent capital, and which they relinquish the right to have divided? So long as every dollar of stock issued by a corporation is represented by a dollar of property, no harm can result to individuals or the public from distributing the stock to the stockholders. Here there was no fraud, no conspiracy, no unlawful combination, and we are bound, under the findings of the court at Special Term, to assume that all this was done in good faith; and we know of no principle of law, no public policy, and no statute that condemns a stock dividend under such circumstances."

If, therefore, the Act be *fairly* construed, the value represented by the stock dividend is included in "invested capital," because, in effect, it, having

been transferred from "surplus" to "capital stock account," represents the actual cash value of tangible property paid in other than cash for stock or shares in such corporation.

VI.

Irrespective, however, of any question as to whether the stock dividend, in effect, amounted to or represented a payment "in tangible property, other than cash for stock in such corporation," still the increase of $9,915,400 was admittedly actually part of the corporation's assets and, therefore is included somewhere in its "invested capital." The express language of the Act includes in "invested capital" "paid in or earned surplus and undivided profits." In "known and ordinary signification" and "as used in common speech," this comprehensive phrase really, in substance, means, the value of its entire assets over and above its corporate liabilities. The context of the Act, therefore, supports and does not repel the construction for which appellant contends.

(a) It was held below that the creation of the stock dividend in 1912 gave no right to appellant to treat it as part of its "invested capital", because, as heretofore decided (*Eisner* v. *Macomber*, 252 U. S. 189, 204, 64 L. Ed. 248, 254, 40 Sup. Ct. Rep. 189, 191), it took nothing from nor added anything to the assets of the corporation, wherefore, it was assumed that technically, there was at the time no specific "tangible property paid in * * * for stock;" in fact, that nothing was paid in *to the corporation*, because the sur-

plus, including the appreciation, was already there. This reasoning is somewhat refined, quite narrow and technical. The only possible question as to upholding a stock dividend is whether there was an actual value which represented the alleged increase. In whatever name carried, the increase constituted part of the assets and therefore was part of the "invested capital." The form in which the increase was held, or by which it was evidenced, was, as already seen (*supra*, Div. IV, subd. d), wholly immaterial. Originally, and when the dividend was declared, the "appreciation," no matter how carried, was part of surplus. The declaration of the dividend simply transferred that increase from surplus to capital stock account (*Eisner* v. *Macomber*, 252 U. S. 189, 211, 64 L. Ed. 248, 254, 40 Sup. Ct. Rep. 189, 194). It cannot be possible that if once in surplus, the entire benefit was lost to appellant by a mere transfer from one account to another, when that transfer was legal (*supra*, Div. V), and when in considering what is surplus the substance, not form, must govern (*supra*, Div. IV, subd. d). If there was not such a transfer, it would remain as it was before for all practical purposes, as part of the surplus, and hence would be within the very letter of the Act.

(b) The lower court erroneously assumed that surplus and undivided profits could not be considered as part of the invested capital, unless they were paid *in cash* or else had been *earned* in the sense of having been *actually realized upon*. This claim distorts the language, and if it prevails, destroys the whole sense of the Act. There is nothing

to indicate that the words "paid in" mean that there must be a payment in actual cash. The surplus or undivided profits may be "paid in" by property, or by accumulations or increases in actual value, as well as by cash. Nor has the word "earned" any technical meaning such as the actual realization and separately setting aside of that which is earned or accumulated as a gain or distinct profit. If a surplus be *acquired or there be given a right thereto or possession thereof*, it is in every sense "paid in or earned."

In III Century Dict. & Ency., 1818, the word "earn" is, among other things, defined to mean:

> "*Acquire* * * *; gain a right to or the possession of."

In VI Century Dictionary, 4757, the word "profit," which is that which is really "earned," is defined as:

> "1. Advancement; improvement. 2. Any advantage; *accession* of good from labor or exertion; *the acquisition of anything valuable*, corporeal or intellectual, temporal or spiritual. 3. Specifically, the advantage or *gain* resulting to the owner of capital from its employment in *any* undertaking."

The word "gain" used in the foregoing definition is, in III Century Dictionary, 2430, thus defined:

> "1. To profit; make gain; get advantage; benefit * * *. 2. To make progress; advance; *increase;* improve; grow; as, to gain

> in strength, happiness, health, endurance, etc.; the patient gains daily * * *. 3. *To accrue; be added.*"

"Accumulated" seems to be the word more generally used (*Eisner* v. *Macomber*, 252 U. S. 189, 211, 64 L. Ed. 248, 254, 40 Sup. Ct. Rep. 189, 195) than the words "paid in" or "earned." *It means* the same *thing* and has been commonly so used as shown by the quotations hereafter made from the New York and New Jersey cases. Therefore, to possess, acquire or accumulate a surplus or undivided profits is the same in effect as to pay them in or earn them.

That the word *earned*, in its ordinary signification, does not necessarily involve the idea of a *physical conversion* of capital or an *actual receipt* of the amount of the gain, is made clear by the case of *Stevens* v. *U. S. Steel Corporation*, 68 N. J. Eq. 373, 380, 59 Atl. Rep. 905, 908, which was a suit to compel the distribution of a dividend, and in which there was involved the interpretation of the term "accumulated profits" used in the statute. The court said of this phrase:

> "Possibly not a tenth of that amount existed as cash—as profits *not only earned, but actually* received * * *. Earned accumulated profits may be a very different thing for the purposes of distribution from accumulated profits. Earnings may be made without ever being received."

From this it is plain that the word *"earned"* was not regarded as synonymous with the words *"actually received."*

(c) "Undivided profits" are part of the assets and really part of the broader word "surplus." This was recognized in *Simcoke* v. *Sayre*, 148 Ia. 132, 126 N. W. Rep. 816, 817, where it was said:

> "The term 'profit' has a larger meaning than 'dividends', and covers benefits of any kind, *excess of value over cost*, acquisition beyond expenditures, *gain or advance*."

In *Anderson* v. *Farmers etc. Co.*, 154 C. C. A. 202, 241 Fed. Rep. 322, 326, the same idea was thus expressed:

> "* * * the words 'capital, surplus and undivided profits' relate to no particular kind of property, but are *expressions describing the amount or residue of the assets after the liabilities have been deducted*."

In *First National Bank of Junction City* v. *Moon*, 102 Kans. 334, 170 Pac. Rep. 33, 35, of undivided profits it was said:

> "Profits not set aside as surplus or distributed in dividends are undivided profits. Surplus and undivided profits are the property of the bank. As the names indicate, they are not capital stock, but are something *besides* capital stock."

In *Eisner* v. *Macomber*, 252 U. S. 189, 211, 64 L. Ed. 248, 254, 40 Sup. Ct. Rep. 189, 194, this court, needing a phrase comprehensive of a corporation's *entire* surplus, used the expression "accumulated profits," thus:

"A 'stock dividend' shows that the company's *accumulated profits* have been capitalized, instead of distributed to the stockholders or retained *as surplus* available for distribution in money or in kind should opportunity offer."

The phrase "accumulated profits" was thus used to describe the *entire surplus*, regardless of the elements of which it was built up. It was clearly not intended as even connoting the *exclusion* of any part, such as "appreciation," from that surplus. The phrase is no broader, nor more comprehensive in meaning than the statutory words "paid in or earned surplus and *undivided profits*." The latter, like the former, do not naturally signify the exclusion of appreciation or any other element actually existing as a part of the surplus.

The increase in value, whether called surplus or undivided profits, admittedly existed in fact. It could lawfully be used as a basis for a true financial statement, as security for *borrowing* money, for paying for the stock in another corporation (*Southern Pacific R. Co.* v. *Lowe*, 247 U. S. 330, 62 L. Ed. 1142) or, as it was in fact, as it legally could be used, as a basis for issuing a stock dividend (*Williams* v. *Western Union Telegraph Co.*, 93 N. Y. 163; *McGinnis* v. *O'Connor*, 111 Md. 695, 72 Atl. Rep. 614; 1 Cook on Corporations (7th Ed.), secs. 287, 536).

(d) But whatever may be the technical meaning of the words "undivided profits," there can be no doubt but that "paid in or earned surplus and undivided profits" of a corporation within

both the letter and the spirit of the act is a general descriptive phrase which (*supra*, Div. V, subd. d), includes everything of an actual value over the debts and capital stock, either as originally issued or subsequently legally increased. Of this there is not a shadow of doubt.

In VII Century Dictionary and Encyclopedia, 6086, "surplus" is thus defined:

> "That which remains above what is used or needed, excess beyond what is prescribed or wanted; *more than enough, overplus.*"

In 14 Corpus Juris, 802, 803, 804, it is said:

> "The term 'net profits' or 'surplus profits' may be defined as what remains after deducting from the present value of all the assets of a corporation the amount of all liabilities, including the capital stock, in other words, that which remains as the clear gain of a corporation, after deducting from its income all the expenses incurred and losses sustained in the conduct and prosecution of its business. Hence a dividend is lawful, if, at the time of its declaration and payment, the corporation is solvent or has assets in excess of the amount of its debts and capital stock. *And it makes no difference whether such surplus assets have been carried on the books of the corporation as surplus, or as segregated assets, or in a special fund account, or otherwise.* Dividends may be paid from surplus *accumulated* out of profits of previous years, although there has been no actual profits for the year in which dividends are paid. The actual value of the assets with which the corporation began business is to be deducted

> and not the nominal share capital, and the business of a corporation is to be viewed as a unit in determining whether or not there are net profits."

In *Eisner* v. *Macomber*, 252 U. S. 189, 209, 64 L. Ed. 248, 253, 40 Sup. Ct. Rep. 189, 194, Mr. Justice Pitney said:

> "The profits of a corporation, as they appear upon the balance sheet at the end of the year, need not be in the form of money on hand in excess of what is required to meet current liabilities and finance current operations of the company. Often, especially in a growing business, only a part, sometimes a small part, of the year's profits is in property capable of division; the remainder having been absorbed in the acquisition of increased plant, equipment, stock in trade or accounts receivable or in decrease of outstanding liabilities. When only a part is available for dividends, the balance of the year's profits is carried to the credit of *undivided profits, or surplus, or some other account having like significance.*"

The corporate surplus, in substance, regardless of form (*supra*, Div. IV, subd. d), is a fund which exists in excess of the liabilities. Of this the authorities leave no doubt. Thus in 1 Am. & Eng. Ency. of Law (2nd Ed), p. 481, it is said that the "accumulated surplus of a corporation is a fund the corporation has in excess of its capital stock after payment of its debts."

In *Bank of Commerce* v. *Tennessee*, 161 U. S. 134, 40 L. Ed. 645, 650, it was decided that ex-

emptions of the stock of the bank from taxation did not exempt its surplus, because the surplus was a different thing from capital stock, being the value of *all* the assets in excess of the liabilities and capital stock. Mr. Justice Peckham there, among other things, said:

> "The surplus belonging to this bank is 'corporate property,' and is distinct from the capital stock in the hands of the corporation. * * * Recognizing, as we do, that there is a different property in that which is described as capital stock from that which is described as corporate property other than capital stock, and remembering the necessity there is for a clear expression of the intention to exempt before the exemption will be granted, we must hold that the surplus has not been granted exemption by the clause contained in the charter under discussion. *The very name of surplus implies a difference. There is capital stock and there is a surplus over, above, and beyond the capital stock, which surplus is the property of the bank until it is divided among stockholders.* * * * No individual shareholder has any legal right to claim any portion of this surplus. Until divided by the board of directors it remains the property of the corporation itself, and in the sense in which the words 'capital stock' are used in the exemption clause the surplus does not form any part thereof. It is said that the purpose of incorporating a bank is to enable the institution to accumulate profits and to make dividends out of them, and that the dividends cannot be made until the profits have been accumulated, and that under this ruling *profits would come under the description of*

surplus to be taxed before distribution in a dividend. It is true that dividends cannot rightfully be made until profits have accumulated; but it is one thing to accumulate profits each six months or annually and then divide them among the stockholders by way of dividends, and quite another thing to accumulate profits year after year, and, while still declaring dividends, *accumulate a surplus* which is not so divided. The sums accumulated by way of profits between the regularly recurring dividend days might not be regarded as surplus, provided those profits were regularly distributed in dividends. *The surplus in this case is clearly not of that kind which has been saved for the purpose of being distributed by dividends.* It may be true that the general effect of a tax on this surplus might indirectly operate upon the shareholder by possibly lessening the value of his shares to some extent, but that is not the same as if a tax had been laid upon those shares."

In *Williams* v. *Western Union Telegraph Co.*, 93 N. Y. 163, the surplus of a corporation was thus defined:

"*When its property exceeds that limit* (the capital stock), *then the excess is surplus.* Such surplus belongs to the corporation and is a portion of its property, and in a general sense, may be regarded as a portion of its capital, *but in a strictly legal sense it is not a portion of its capital, and is always regarded as surplus profits.* * * * *But here it is found that over and above its capital it possessed property actually worth upward of* $15,000,000, and we know of no law that is violated, and no public policy that is in-

> vaded by issuing to the stockholders stock to represent that amount of property rather than in any mode to divide it up and distribute it among them. * * * The company had made surplus earnings which it could have divided, but instead of dividing them it had invested them in property to facilitate and enlarge its business; *and such property was found to be worth $15,520,590. That sum constituted* its surplus * * *."

In *First National Bank of Junction City* v. *Moon*, 102 Kan. 334, 170 Pac. Rep. 33, 35, it was said:

> "Capital stock is still and always the original fund subscribed by the stockholders at the inception of the organization, and stands as a liability on the books of the bank, instead of as an asset. The bank makes some money. Profits belong to the corporation, and can be disposed of by the board of directors only, not by the stockholders. The stockholders have no property in profits until the directors have declared a dividend. In order to create a fund to meet unforeseen contingencies and unusual losses, the bank does not distribute all the profits among the stockholders, but retains some of them. The fund so created is designated surplus. *Profits not set aside as surplus or distributed in dividends are undivided profits.* Surplus and undivided profits are the property of the bank. As the names indicate, they are not capital stock, but are something *besides* capital stock. After paying for the number of shares of capital stock which he has subscribed, the stockholder's right to claim money or property from the bank and its business is limited to sharing

in such dividends as may be declared by the board of directors out of profits, and to sharing in the distribution of the assets of the bank when it winds up its affairs, after depositors and all other creditors have been satisfied. This right attaches to and is proportionate to the number of shares of capital stock which the stockholder owns. His shares are his personal property, and they may be bought and sold as other personal property, by the observance of certain formalities. They may be willed away, and in case of intestacy pass to his administrator as a part of his personal estate. He cannot sell or will away any part of the money or property which belongs to the corporation."

In *Fidelity Trust Co.* v. *Board of Equalization*, 77 N. J. L. 128, 71 Atl. Rep. 61, 62, it was said:

"In order to ascertain the capital and *surplus* it is necessary to find the *true* value of the gross assets. From this must be deducted debts and liabilities. The remainder will be the *value of the capital and surplus*, if any. * * * This method of assessment is only a mode of ascertaining the value of the property of the trust company above its liabilities. Of course, it presupposes that the values used to this end are *true* values within the constitutional meaning."

In *Leather Mfrs.' Nat. Bank* v. *Treat*, 116 Fed. Rep. 774, 775, Judge Lacombe said:

"The only question presented is whether the word 'surplus,' as used in the phrase 'in estimating capital surplus shall be included,'

is to be construed as having some restricted meaning, or *in its natural and ordinary sense, as including the entire overplus of assets over liabilities.* * * * And it would seem absurd to hold, though it seems to be a natural corollary from the propositions advanced by plaintiff, that a board of directors could set aside large sums each year from the profits, accumulating an additional fund equal perhaps to the capital, and used in the same way, and escape the tax upon it by the simple device of calling it 'undivided profits.' It would seem rather *that Congress used the word 'surplus' in its ordinary sense, as indicating the amount* left over after setting aside sufficient of the assets of a banker to meet his liabilities."

In *Anderson* v. *Farmers' Loan & Trust Co.*, 241 Fed. Rep. 322, 324, 327, 154 C. C. A. 202, Judge Hand said:

"The capital, surplus and undivided profits are simply what may be left after the satisfaction of the liabilities to depositors and other creditors. The creditors may be paid out of any portion of the assets of the company, and the capital, surplus and undivided profits represent a residue which, like the claims of creditors, may be made good out of any of the securities, cash, bills of exchange, promissory notes, or other resources of the bank, including its real estate. No segregation took place, and *the attempted segregation was an artifical transaction that in our opinion had no* reality. The statute upon any other theory becomes futile and meaningless, and enables any bank holding investments equivalent in value to its capital, surplus and

> undivided profits exempt from any franchise tax under the War Revenue Act. * * * The capital, surplus and undivided profits, which counsel for the defendant in error insists were not employed in banking, but were permanent investments, we regard as employed in all the business of the bank of every kind. They were available for any use, equally with all other assets of the company, and were therefore employed both in the banking and other business. And this is because the words 'capital, surplus, and undivided profits' relate to no particular kind of property, *but are expressions describing the amount of the residue of the assets after the liabilities have been deducted.*"

In *People* v. *Tax etc. Com'rs*, 76 N. Y. 64, 74, it was said:

> "Surplus earnings is an amount owned by the company over and above the capital and actual liabilities * * *."

In *People ex rel.* v. *Purdy*, 161 App. Div. 541, 146 N. Y. Supp. 646, 647, it was, as to the surplus of a corporation, said:

> "This was less than the amount of the outstanding capital stock, and consequently it appeared upon the face of the statement that the relator had no surplus, for the surplus of a corporation has been defined to be 'the *accumulations* of the company of moneys or property in excess of the par value of the stock issued by it.'"

In *People ex rel. v. Barker*, 165 N. Y. 305, 59 N. E. Rep. 137, 138, surplus profits were thus defined:

> "As we understand this statute, the *surplus profits* or reserved funds mean the *accumulations* of the company of moneys or property in excess of the par value of the stock issued by it."

These quotations find abundant support in *People ex rel. v. Coleman*, 126 N. Y. 432, 28 N. E. Rep. 818, and *Hemingway v. Hemingway*, 181 Mass. 406, 63 N. E. Rep. 919.

In *State, People's Fire Ins. Co. v. Parker*, 34 N. J. L. 479, 482, 483, it is said:

> "What constitutes its accumulated surplus gives rise to this controversy. * * * The policy of the tax law will be effectuated by bringing within its operation all property to which it can be fairly applied. The term surplus, as applied to an insurance company, is the fund it has in excess of its capital stock after payment of its debts. * * * The act under which the tax was imposed was designed to promote equal taxation, and to that end to reach so much of the property of these corporations as is not represented by their capital stock."

In *State, People's Fire Ins. Co. v. Parker*, 35 N. J. L. 575, 576, 577, Judge Scudder said:

> "There is no question about the capital stock, but whether all the assets of the company, in excess of their capital stock, as shown by their statement of May 1st, 1869,

ratable as accumulated surplus, is the point of controversy. These assets are not represented by the capital stock, but stand distinct from it, and beyond it; they are, therefore, in some sense, a surplus. This word is defined as 'overplus'; that which remains when use is satisfied; excess beyond what is prescribed, or wanted, in law; the residue of an estate after the debts and legacies are paid. 'Accumulated' is simply amassed, collected, heaped up. With these definitions in mind, we have the guide to find the legislative intention. As applied to banking institutions, these words have a well-settled meaning, and this was probably in the contemplation of the Legislature when framing this section, although such institutions are excepted from its provisions. The earnings of banks arising from discounts, and interest on investments, are carried into the surplus account, and paid over, after deducting expenses and ascertained losses, at certain periods, to stockholders, as dividends, reserving, however, such portion as the directors may deem proper, as a fund to increase the capital employed in conducting the business of the company, and to provide against contingent losses. This fund is called accumulated surplus. The analogy between these discounts of banks and the premiums on policies of insurance, is certainly very close. One is a premium paid for a loan; the other, a premium paid for a fire risk. Both are earnings. They are earned, in the one case when the loan is actually made; in the other when the risk is assumed and begun. A similar disposition may be made of them. A certain portion—so much as may be thought safe in the due course of business—may be paid over to

> stockholders as dividends; a certain other portion, in the exercise of an honest judgment, and for better security, should be retained in the hands of the corporation, as a provision against contingent losses. This amount should always have relation to the sum of outstanding policies, and the estimated liabilities, in the usual course of business. It is thus surplus capital, or accumulated surplus, employed in conducting the business of the company. It stands to them in the place of an increase of capital, by calls on the stockholders, which might be necessary to cover the amount of their risks. Instead of adding to the capital directly, by calls, these premiums are funded. The company derives income from them, and holds them equally with capital, liable for losses. In case of banking and stock insurance companies, the provision is made against contingent, and not ascertained and certain losses; not against present debts, but possible liabilities. Debts and losses are first deducted, and the balance is held as a fund against contingencies. As defined by the Supreme Court, it is the fund the corporation has in excess of its capital stock after payment of its debts."

Therefore, a "surplus" and the "undivided profits" are paid in or earned whenever they have been "acquired or accumulated." So it was recognized and so were the terms used in *Eisner* v. *Macomber*, 252 U. S. 189, 64 L. Ed. 248, 40 Sup. Ct. Rep. 189.

VII.

Congress refused to embody in the law an express exclusion of appreciation. The court below construed it as if it nevertheless contained such express exclusion. Such a construction should not be adopted for it would make the Act violative of the Fifth Amendment to the Constitution.

(a) The forced technical and extraordinary view adopted below is this:

> There was, *in fact*, a surplus of $9,915,400 *actual* cash value, consisting of the increase in value of these ore lands. Though this surplus admittedly existed and the corporation admittedly owned it, still it was not "earned" because it had not been actually "realized." In plain words, it could not be "earned" until the property should be actually disposed of, nor until the value represented by the appreciation should be transformed into something other than these ore lands, i. e., into some property *physically* different, although of exactly the same value, and although of exactly the same kind.

(b) The language of the statute does not specifically require a "realization" by sale or otherwise. On the contrary, the proposed amendment of the Act of 1917 (*supra*, Div. III), which would have in terms so required, was absolutely rejected by Congress. That rejection was equivalent to a congressional declaration that the phrase "paid in or earned surplus and undivided profits" adequately designated certain elements which should, as in ordinary signification it

actually does, constitute part of "invested capital," and was also equivalent to a refusal to say that it should *not* include "the increase in the value of any asset above the original cost until such increase is actually realized by sale." The meaning which Congress thus so unequivocally *refused* to ascribe to the phrase is precisely that which the government attempts to here give it. If the legislative *intention* is the goal to be sought in statutory construction, there surely exists here a most unusual aid in ascertaining that intention, i. e., the action of Congress itself. As to such action, it may be repeated that in *Dunlap* v. *United States*, 173 U. S. 65, 43 L. Ed. 616, 619, Mr. Chief Justice Fuller remarked:

> "* * * it is nevertheless interesting to note that efforts were made in the Senate to amend the bill * * *; that these proposed amendments were rejected * * *."

The circumstances under which Congress took that action are these: The exact phrase had been in the statute since its final approval October 3, 1917. The Department had early adopted the view (Regulations 41, article 55) that the words "paid in or earned surplus and undivided profits," *sometimes* did and *sometimes* did not, until such increase was actually realized by sale, include the actual value of any asset above the original cost. A year later, Congress was asked to specifically declare that these words did not include any such appreciation. The House assented and passed the amendment. Had the Senate also passed it, there

would have been adopted the construction here sought to be maintained. But the Senate struck out the proposed amendment. On February 24, 1919, *Congress as a whole*, by passing the act without amendment, recorded its refusal to sanction the construction now contended for by the government. There could be no clearer evidence that it was *not* the intention of Congress to exclude such increase in value. In the face of this unmistakable action of Congress, and the *plain words* of the statute to the contrary, it was below held and is now here contended that it was nevertheless actually intended that the $9,915,400 of appellant's admitted value, *actually used by it in creating the very income which was the source of the tax*, could not be included so long as appellant *itself* continued to own and to use in its business this actual cash value of $9,915,400 *in the form of these ore lands*. At the same time, such value *would* have been included (Regulations 41, article 55; Income Tax Rulings 28-20, p. 17, id. 34-20, p. 25, Sol. Op.) if, and as soon as, its *form* was so changed that appellant would own, instead of the precise lands to which this value attached, other ore lands precisely similar, but *physically* different, or something else, no matter what, having equal value. In other words, the test made was the *ownership* of the property, not the actual *value* devoted to earning the taxable income. This cannot be. Only the clearest legislative pronouncement would even justify, much less require, the ascription of such meaning to a statute basing a tax on *value*. This should not be done, especially when, as here, Congress,

by refusing to adopt the proposed amendment, clearly pronounced that the statute could have no such meaning.

(c) The view adopted below was that though declining to specifically exclude from invested capital increases in value not realized by sale, Congress has nevertheless intended that the *unamended* general phrase meant precisely the same thing. In considering this view, there should not be overlooked some of the consequences, by way of discrimination, which would result from its adoption. This is always proper, for in *Bate Refrigerating Co.* v. *Sulzberger*, 157 U. S. 1, 37, 39, L. Ed. 601, 611, Mr. Justice Harlan said:

> "Undoubtedly the court when endeavoring to ascertain the intention of the legislature, may be justified, in some circumstances, in giving weight to considerations of injustice or inconvenience that may arise from a particular construction of a statute."

Moreover, an act of Congress should never be given a construction which would render it unconstitutional unless such construction is imperatively required (*U. S.* v. *Central P. C. R. Co.*, 118 U. S. 235, 30 L. Ed. 173, 178).

In *Brushaber* v. *Union Pacific R. Co.*, 240 U. S. 1, 24, 60 L. Ed. 493, 504, Mr. Chief Justice White, in referring to the doctrine or contention that the due process clause of the Fifth Amendment is not a limitation of the taxing power conferred on Congress, said:

> "And no change in the situation here would arise even if it be conceded, as we think it

must be, that this doctrine would have no application in a case where, although there was a *seeming* exercise of the taxing power, the act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation, but a confiscation of property; that is, a taking of the same in violation of the 5th Amendment; or, what is equivalent thereto, *was so wanting in basis for classification as to produce such a gross and patent inequality* as to inevitably lead to the same conclusion."

This is the last word on the subject.

(d) The Act, so construed, is "so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead" to the conclusion that it amounts to "a confiscation of property, that is, a taking of the same in violation of the 5th Amendment." This substantiates the claim heretofore (supra, Div. III) outlined, that Congress did not, in refusing to adopt the amendment, nevertheless intend the unchanged words to mean what they could mean only if the amendment had been adopted. Such want of basis for classification, as was described in the Brushaber case, exists if the Act be given the construction adopted below. This is not only demonstrable from its express language, but also from the rulings of the Department applying and construing it. These demonstrate that the grossest inequalities are permitted to result from *mere accidents in form*. It is only the *form*, not the substance, of the transaction, which, under that construction, caused the imposition of a tax *for a single year*,

of $1,081,184.61 *more* than would have been imposed had such transaction taken one of several other *forms*. In plain words, had the paper transaction been, as it so easily might have been, slightly different, the heavy tax complained of would not have been imposed. Thus, if appellant, instead of paying $190,000 cash for the ore lands in 1904, had paid therefor with its stock of a *par* (not actual) value equal to or greater than $10,105,400, it would, *under the express language of the statute*, undoubtedly have been entitled to include in its "invested capital" the "appreciation" of $9,915,400. There can be no dispute about this, for the Act itself provided that "invested capital" of a corporation includes "the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, *the actual cash value of such property as of January first, nineteen hundred and fourteen*, but in no case to exceed the par value of the original stock or shares specifically issued therefor)." The statutory rule was embodied in Regulations No. 41 of the Department, article 55 of which provides:

> "Tangible property paid in for stock or shares prior to January 1, 1914, must be valued at either (a) the actual cash value of such property on January 1, 1914, or (b) the par value of the stock or shares specifically issued therefor, whichever is lower. This is one of the *few* cases in which the law permits allowance to be made for appreciation."

So, if appellant instead of capitalizing the appreciation on these ore lands by the stock dividend of 1912, had *then* formed a subsidiary corporation and transferred the property to it for $10,105,400 par value of its stock, and had distributed to its own stockholders the stock of the new subsidiary, *then*, under the statute, irrespective of the amount or *par* value thereof, the ore lands would have been permitted a value as a part of "invested capital" *of the full $10,105,400 which would, of course, have included the appreciation of $9,915,400.* Of this there can be no question, for subdivision 2 of section 207 of the Act (Rec. 3) provides specifically that invested capital includes in the case of a corporation:

> "The actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, *at the time of such payment.*"

It would make no difference whatever that, in fact, there would have been in such a case no real change of ownership, i. e., no actual "realization," such as the government contends is a prerequisite to the inclusion of this enhanced value in invested capital. Such has been the ruling of the Internal Revenue Bureau itself. (Income Tax Rulings 28-20, p. 17). There it appeared that the property of Corporation A and the property of Corporation B were transferred to Corporation C ("organized in 1911 as a consolidation" of A and B), but *"there was no substantial change in interest* at the time of reorganization, *the stockholders of the new corpor-*

ation being practically the same as the old." It was by the Committee on Appeals and Review held that *the amount of appreciation in value* of the properties *should, under the statute, be included* in the invested capital of Corporation C, and not restricted to the original cost thereof to A and B. In other words, the holding was that "though there was no substantial change of ownership," i. e., though there was, in fact, no actual "realization," the transaction should be considered as amounting to a conveyance to C of tangible property "clearly and substantially in excess of the cash or the par value of the stock or shares paid therefor," within the meaning of those words as used in article 63 of Regulations 41.

In addition to this ruling there was adopted by the Department a published opinion of the Solicitor of Internal Revenue. (Income Tax Rulings, 34-20, p. 25, Sol. Op. 41.) The substance of that opinion clearly appears from this head-note thereto:

> "Where a corporation transfers its property to an association *composed of its stockholders*, and the association after January 1, 1914, but prior to March 3, 1917, transfers substantially the same assets to a new corporation, *the fair market value of such assets when transferred to the new corporation should be included* in determing the invested capital of the latter. * * *"

It is thus obvious that—if the Act requires the construction ascribed to it by the government—appellant is obliged to pay a tax of $1,081,184.61 more than it would pay *had it chanced* to pay

for these ore lands in stock "watered" to the outrageous extent of $9,915,400, or, *had it chanced* to transfer these ore lands in 1912 to a subsidiary. In neither instance would the actual cash value of the property actually owned by appellant, actually devoted by it to earning the source of the tax, have been different by one penny from what it actually was on January 1, 1917. In neither instance would appellant's "capital," "surplus," "investment," or "profits" have varied one iota from what they were in fact and in truth on January 1, 1917. Those corporations, and they must be numerous, which did issue "watered" stock for property before 1914, and those, and they must also be numerous, which were formed by consolidation of other corporations, without any *real* transfer or change of ownership, are rewarded, and appellant penalized to the extent of $1,081,184.61 for 1917 *and for every year the statute continues in effect, merely because of the form the transaction chanced to take.* For Congress to say, in substance, *first*, that such corporations as *chanced*, long before the adoption of the Sixteenth Amendment, to issue watered stock for property shall be taxed *at a different and lower rate* than corporations which paid cash for their property; or, *second*, that such as *chanced*, long before the adoption of that amendment, to be formed by taking over the assets of earlier-formed corporations, even though there was no change in real ownership, should be taxed *at a different and lower rate* than the constituent corporations together would be taxed if there *chanced* not to be such consolidation, is to pre-

scribe mere *chance* or mere *form* as a basis for classification—a basis so arbitrary, so wanting in proper basis for classification as to lead inevitably to one of two conclusions, either, that is, that the Act is a confiscation of appellant's property in violation of the Fifth Amendment, or that Congress could *not* have meant it to have the meaning ascribed to it, which would achieve an unconstitutional result.

Respectfully submitted,

NATIONAL LUMBER MANUFACTURERS' ASSOCIATION, *Amicus Curiae.*
By MASSEY HOLMES,
FRANK HAGERMAN,
Its Counsel.

Kansas City, Mo.,
December 20, 1920.

SUPREME COURT, U. S.
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No. 453.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1920.

LA BELLE IRON WORKS, *Appellant*,
vs.
THE UNITED STATES, *Appellee*.

APPEAL FROM THE COURT OF CLAIMS.

ARGUMENT BY THE LONG-BELL LUMBER COMPANY AS AMICUS CURIAE IN SUPPORT OF THE ASSIGNMENTS OF ERROR.

JESSE ANDREWS,
Solicitor for The Long-Bell Lumber Co.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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The solicitors of The Long-Bell Lumber Company, a Missouri corporation, having its principal place of business at Kansas City, Missouri, have had the privilege of reading the brief of Appellant, and, with full concurrence in all that is therein said, desire to add, under leave of Court granted, a short argument referring to but one point developed by the brief.

POINT

"Tangible property paid in other than cash for stock or shares in such corporation" as the expression is used in clause (2) of paragraph (a) of Sec. 207 of the Revenue Act of 1917, means tangible property on account of which stock is lawfully issued, and includes tangible property acquired by the corporation from others, for which stock is issued, *and* tangible property already owned by the corporation, on account of the surplus created by which additional stock is issued.

SUB-POINT 1

It is to be presumed that in enacting the Revenue Act of 1917, Congress had in mind the right of corporations to issue additional stock as dividends, paid for in property *already owned*, the profit in which is reflected on the liability side of the balance sheet as surplus, and the probable exercise of that right, from time to time, by corporations.

The right was well settled at the time, as evidenced by the text writers and the adjudicated cases.

In 2 Cook on Corporations (6th Ed.), 536, it is said:

> "A stock dividend, as the name imports, is a dividend of the stock of the corporation. Such a dividend is lawful when an amount of money or property equivalent in value to the full par value of the stock distributed as a

dividend has been *accumulated and is permanently added to the capital stock of the corporation.* Corporations frequently make a dividend of this character when improvements of the corporate property or extensions of the business have been made out of the profits earned. It is also made when the corporate plant *has increased in value*, and it seems better to issue new stock to represent the *excess* value than to sell the increase and declare a cash dividend. In this country these dividends are frequently made, and are sustained by the courts."

See also: Thompson on Corporations, §2167; Morawetz on Corporations (2nd Edit.), §452; Gibbons vs. Mahon, 136 U. S., 549; Williams vs. Western Union Telegraph Co., 93 N. Y., 162; Lantz vs. Moeller, 136 Pac. (Wash.), 687, 50 L. R. A. (N. S.), 68; McGinnis vs. O'Connor, 111 Md., 965, 72 Atl., 614.

Sub-Point 2.

It is not to be thought that Congress intended to allow earnings (prior to the taxable year) to be treated as a part of invested capital when appearing in the balance sheet as *surplus*, but did not intend to allow such earnings to be so treated when converted from surplus into capital stock by a stock dividend and appearing as *capital stock* in the balance sheet; and yet (assuming, for the purpose of the argument, that invested capital includes only what is specifically stated in Section 207 to be included) the Act contains no language

authorizing the inclusion in the computation of invested capital of *property* purchased by the corporation *with its earnings* and later made the basis of the issuance of additional stock by a stock dividend *unless* the language, "tangible property paid in other than cash, for stock or shares in such corporation," does so.

There is language in the Act which permits the inclusion for such purpose

> (a) of *cash* paid in (the language is "Actual cash paid in"), and
> (b) of paid in or earned *surplus* (the language is "paid in or earned surplus and undivided profits, used or employed in the business, exclusive of undivided profits earned during the taxable year);

but the only language upon which could be based the inclusion of property purchased with earnings and *thereafter* made the basis of a stock dividend is

> (c) "tangible property paid in other than cash, for stock or shares in such corporation."

An intention cannot be imputed to Congress to have such property included in the computation of invested capital when it is reflected in the balance sheet as "surplus," but not to have it included when afterwards it is reflected there as "capital stock."

A few illustrations (using what might be the balance sheets of a corporation at successive periods)

may aid in the expression of our thought at this point:

(1)

Assets		Liabilities	
Plant	$50,000	Capital Stock	$50,000
Cash in bank from earnings	40,000	Surplus	40,000
	$90,000		$90,000

Invested Capital, $90,000.

---

(2)

Plant	$50,000	Capital Stock	$50,000
Plant No. 2, paid for with cash from earnings	40,000	Surplus	40,000
	$90,000		$90,000

Invested Capital, $90,000.

---

(3)

Plant	$50,000	Capital Stock	$90,000
Plant No. 2 (above)	40,000		
	$90,000		$90,000

Invested Capital, $90,000.
(A stock dividend has been declared.)

In illustration (2) the property purchased with earnings is reflected in "surplus;" in (3) in "capital stock."

It must be accepted as true, therefore, that it *was* the intention of Congress to include in "tangible property paid in for stock" property already owned by the corporation acquired with its earnings, and which has been made the basis of the

issuance of additional stock through a stock dividend.

SUB-POINT 3.

But as the authorities all show, stock may be issued by means of a stock dividend against *any* sound surplus that the corporation may have, including as well that resulting from an increase in the value of property owned by it as that purchased with earnings (2 Cook on Corporations, 536; Lantz v. Moeller, 136 Pac. (Wash.), 687, 50 L. R. A. (N. S.), 68; and McGinnis v. O'Connor, 111 Md. 695, 72 Atl., 614), and no language is used in the Act to indicate that it was intended *by Congress* to make a distinction between *some* tangible property (the value of which when paid in for stock may, as we have seen, be included in the computation of invested capital) and other such property. The language is "tangible property paid in other than cash, for stock or shares in such corporation," and includes *all* tangible property.

SUB-POINT 4.

The statutes or the decisions of many states require that property shall be "paid in" for stock before the stock is issued; but this language has not been construed to mean that the corporation must necessarily receive something which it had not previously owned. On the contrary it has been held that the requirement is satisfied if property, already owned by the corporation, is made the basis of a new issue of stock, the excess value of

which property was, just prior to the time, reflected on the liability side of the balance sheet, in surplus.

In Connecticut there was a statute which provided that "no corporation shall issue any certificates for stock until the stock has been subscribed and *paid for in full.* The treasurer of such corporation shall issue and deliver to each subscriber a receipt, countersigned by the secretary and under the corporate seal, stating the amount such subscriber has paid on his subscription and the number of shares of full paid and nonassessable stock for which he or his transferee, upon the payment of the balance due upon his said subscription, would be entitled to receive a certificate, etc." (Pub. Acts 1903, Chapter 194, Sec. 12.) In October, 1909, the Yale & Towne Manufacturing Company, a Connecticut corporation, in the judgment of the directors, had an actual surplus over and above all liabilities, capital stock included, of more than $500,000, and the directors, pursuant to a vote of a large majority of the stockholders, ordered that 5,000 new shares should be issued as fully paid up and delivered to the stockholders pro rata, and that in full payment therefor, the treasurer should transfer on the books of the company $500,000 from surplus to capital stock. The board also entered on the record book of the company a statement that it had declared a stock dividend of 33 1/3 per cent, that the actual surplus of the company exceeded $500,000, and that there

had been received in payment for the stock $500,000, in actual value of the surplus of the company, carried to and merged in capital stock. Certain stockholders who had voted against the increase sought to enjoin the delivery of the new stock on the ground that it would be in violation of the statute referred to and particularly of the portion quoted. But the Court held the contrary and denied the injunction. (Stamford Trust Co. v. Yale & Towne Mfg. Co. *et al.*, 75 Atl.(Conn.) 90.) The Court said:

> "The term 'capital stock' of a corporation, taken in its strict and primary sense, 'is employed to designate specifically the fund, property, or other means contributed, or agreed to be contributed, by the share owners as the financial basis for the prosecution of the business of the corporation; such contribution being made directly through stock subscriptions, or indirectly through the declaration of stock dividends. As thus used, the term signifies those resources whose dedication to the use of the corporation is made the foundation for the issuance of certificates of capital stock, and which, as the result of the dedication, become irrevocably devoted to the satisfaction of all the obligations of the corporation.' Smith v. Dana, 77 Conn., 543, 552, 60 Atl., 117, 69 L. R. A. 76, 107 A. St. Rep. 51. The directors, and a majority largely exceeding two-thirds of the shareholders of the defendant, have determined to make such a dedication of a large amount of accumulated property, representing a surplus, which is invested in the plant and

business, but, unless some such step be taken, might at any time be diverted from the uses of the corporation to those of the shareholders, by turning it into cash and declaring a dividend therefrom. The plan adopted is that of making a stock dividend. There can be no doubt that such action was fully within the power of its directors. * * *

No limitations which militate against such a stock dividend are imposed by the defendant's charter or by any statute. The letter of section 12 gives some support to the plaintiff's contention, but is controlled by its spirit and object. That object plainly was two-fold: To preclude the issue of certificates for stock until the shares are fully paid for; and to prevent the acceptance of property other than cash in payment, at a valuation greater than the sum which it is actually worth. Read with reference to the mischief which it was designed to remedy, it extends to every case in which one claiming the position of a shareholder seeks to obtain a certificate of stock. Its controlling purpose is to prevent the issue of any certificate of stock for shares that have not been fully paid up, because such a certificate might mislead those dealing with the holder by inducing them to suppose that his stock was liable to no assessments. To give it this effect the word 'subscriber' must, and properly, may be taken as used to include every shareholder, whether he might become such by signing a subscription paper, or by purchase from one who had so subscribed, or from his assigns, or by purchase from the corporation. In none of these cases can a certificate of stock be issued until the share has in some way been fully paid up."

In the State of Washington, three stockholders, the owners of all the stock of a corporation, and another subscribed for the additional stock authorized by an amendment of the charter, $41,400 par value, and by this subscription agreed to pay for the additional stock by conveying to the corporation certain real estate owned by them and certain real estate and building contracts and bills receivable owned by the corporation. The value of the interest of each in the respective pieces of real estate was stated and also in the assets of the corporation (being the real estate, building contracts and bills receivable) after deducting the amount of its capital stock and debts, the whole aggregating $41,400. The company later becoming insolvent and a receiver having been appointed, an assessment, authorized by the court was made. Suit was brought to enforce the assessment. (Lantz v. Moeller, 136 Pac. 687; 50 L. R. A. (N. S.) 68, 71.) The Court said:

> "The first question that must be determined is whether or not the assets of the original corporation, after deducting the amount of its capital stock and debts, can be applied on the subscription contract to the increased capital stock. The appellant argues that the assets of the original corporation, over and above the amount of its capital stock and debts, if any, cannot be applied in payment of the increased capital stock, and that the only question in the case is: Was the value of the property turned over by the individual subscribers equal to the par value of the stock subscribed for? This

position is not tenable. If the assets of the original corporation on April 1, 1909, exceeded its debts and the amount of the capital stock, the excess might be applied *in payment* of the increased capital stock which had been subscribed for by the stockholders of the original corporation. This would be in the nature of a stock dividend. 2 Clark & M. Priv. Corp., p. 1603; 1 Cook, Corp., 6th Ed. §287. The latter citation states the rule thus: 'A frequent method of issuing an increase to the capital stock is by stock dividend; * * * but, in all cases of a stock dividend as a method of issuing an increase of the capital stock, there must be in possession of the corporation an amount of property over and above its corporate debts equal to the whole capital stock, including the increase, and this amount cannot afterwards be used for any kind of a dividend."

"It is true that Sheer owned no stock in the old corporation and would therefore have no interest in its assets, but if all of the stockholders, by agreement, grouped their interest in the assets, together with the individual property of themselves and an outsider, and intended that the total should be considered as one fund to liquidate the subscription, it would appear that, if the total was equivalent to the par value of the stock as increased, less the capital stock and debts of the original corporation, it would operate *as payment of the subscription.*"

As stated elsewhere in the same opinion (p. 73) the rule in Washington is that "the stock subscribed for must be paid in cash or in property of equiva-

lant value. In other words, the corporation must be in the actual condition which it represents itself to be in financially."

A North Carolina statute (Revisal 1905, Sec. 1161) provides:

> "Any corporation formed under this chapter may *purchase* mines, manufactories or other property necessary for its business, and issue stock to the amount of the value thereof in payment therefor, and the stock so issued shall be full-paid stock, and not liable to any further payment under any of the provisions of this chapter; and in the absence of actual fraud the judgment of the directors as to the value of the property shall be conclusive, etc."

The Carolina Ice Company, a corporation of that state, had become insolvent and receivers had been appointed. Suit was filed by the receivers against one of the stockholders on the ground that nothing of value had been paid on the stock owned by him. He held part of the original issue, paid for by the assignment of a patent to the corporation, and certain stock issued as a stock dividend and paid for out of surplus. The issue, as it was left by the Court after reversing the case (Whitlock v. Alexander, 76 S. E. (N. C.) 538), was whether the property on account of which the stock (each kind) was issued was so grossly disproportionate in value to the amount of the stock as to warrant a finding that the stock issues were fraudulent. It is of some significance here that while the statute au-

thorizes an issue of stock for property *purchased*, it seems to have been assumed by all of the parties to this suit that the use of property already owned by the corporation (to the extent of its surplus value) for the payment of stock was tantamount to *a purchase by the corporation.*

A statute of Kentucky (Chapter 56, Gen. St. Ky., 1883, Sec. 5) requires that a charter when filed, among other things, must state "the highest amount of indebtedness or liability to which the corporation is at any time to subject itself;" and the Court of Appeals of Kentucky construes the amount so stated in the charter as an absolute limitation of the corporation's powers in that direction, and a negation of the validity of any excess of indebtedness beyond the sum so fixed, although the corporation itself would be estopped from setting up such a defense. Scanlan & Company, a Kentucky corporation, had stated in its charter that this limit should be one-half of the paid-up capital stock of the company. In a contest between creditors, after the corporation became bankrupt, it was necessary to decide whether the limit had been exceeded. This depended on whether certain stock issued as a stock dividend was fully paid. The charter had been amended to increase the authorized capital stock from $40,000 to $150,000. The corporation in the early part of its history continued to make profits, and for the profits new stock was issued as paid-up and divided among the stockholders. The aggregate of all such stock, old and new, was more than twice the amount

of all of the indebtedness. The Circuit Court of Appeals of the Sixth Circuit (Cunningham *et al.*, v. German Ins. Bank, 41 C. C. A., 609, 613, 101 Fed., 977) held that the indebtedness was valid, Judge Severens saying this with respect to the stock dividend: "The issuing of stock in lieu of dividend was not unlawful. It was the same thing as if the dividends had been actually paid over, and then, by the stockholders, *repaid to the company for the stock.*"

Being fully aware that oftimes stock is issued as paid for in property rather than in money, Congress, when it reached clause (2) paragraph (a) of Sec. 207, in the preparation of the Revenue Act of 1917, undertook to lay down a rule for determining what allowance for such property should be made in the computation of invested capital. It did not use the words "paid in" in a restrictive or exclusive sense as referring only to property passing to the corporation from others, but rather as expressing the idea common in the State statutes and decisions and exemplified in the Connecticut case,—*property on account of which a valid issue of stock is made.*

Sub-Point 5.

The property, on account of the surplus created by which a stock dividend is lawfully issued, is in effect "paid in" to the corporation. It is segregated from those funds out of which a cash dividend may be paid, and becomes thereafter unavailable for that purpose.

In Williams v. Western Union Telegraph Company (93 N. Y., 162, 190), the leading case on the subject, it is said:

> "But here it is found that over and above its capital it possessed property actually worth upwards of $15,000,000, and we know of no law that is violated, and no public policy that is invaded by issuing to the stockholders stock to represent that amount of property rather than in any mode to divide it up and distribute it among them. If it can issue stock in payment of property to be obtained by it as part of its capital for its legitimate uses, why may it not issue stock to its stockholders in payment for property *in effect purchased of them* and added to its permanent capital, and which they relinquish the right to have divided?"

One who has a certificate of stock issued as a part of a lawful stock dividend has a share on account of the ownership of which no assessment can be made. It is "fully paid up." To be "fully paid up" there must have been something paid in for it in contemplation of law.

Sub-Point 6.

Property owned by the corporation, on account of the surplus created by which a stock dividend is issued, becomes thereby as much paid in for the new stock as would property paid in for stock by an outsider.

This may be illustrated by considering, first,

what might be the balance sheets, at successive periods, of a corporation having a surplus resulting from an increase in the value of its property that pays a cash dividend and afterwards sells additional stock for cash, and, second, the balance sheets where the excess value of the assets is paid in for additional stock by a stock dividend.

First

(1)

Assets		Liabilities	
Plant and other property	$300,000	Capital Stock	$500,000
Ore lands*	200,000	Surplus	100,000
Total	$600,000	Total	$600,000

*Cost $200,000; actual cash value, $300,000.

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(2)

Assets		Liabilities	
Plant and other property	$300,000	Capital Stock	$500,000
Ore lands	300,000	Surplus	100,000
Cash in bank	100,000	Bills payable	100,000
Total	$700,000	Total	$700,000

(This would be the condition after borrowing $100,000.)

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(3)

Assets		Liabilities	
Plant and other property	$300,000	Capital Stock	$500,000
Ore lands	300,000	Bills payable	100,000
Total	$600,000	Total	$600,000

(This would be the condition after paying a cash dividend of $100,000.)

(4)

Assets		Liabilities	
Plant and other property	$300,000	Capital Stock	$500,000
Ore lands	200,000	Bills payable	100,000
Cash	100,000		
Total	$700,000	Total	$700,000

(This would be the condition after selling $100,000 of stock for cash.)

(5)

Assets		Liabilities	
Plant and other property	$300,000	Capital Stock	$600,000
Ore lands	300,000		
Total	$600,000	Total	$600,000

(This would be the condition of the company after using the cash on hand to retire its bills payable.)

It will be observed that at stage (5) the company would have $600,000 of valid stock outstanding, $100,000 of which was supported by the difference between the cost and the actual cash value of the ore lands—and this notwithstanding the additional stock was issued for cash.

Second.

The balance sheets if a stock dividend was declared would be these:

(1)

Assets		Liabilities	
Plant and other property	$300,000	Capital Stock	$500,000
Ore lands*	300,000	Surplus	100,000
Total	$600,000	Total	$600,000

*Cost $200,000; actual value, $300,000.

(2)

Assets		Liabilities	
Plant and other property	$300,000	Capital Stock	$600,000
Ore lands	300,000		
Total.....	$600,000	Total.....	$600,000

(This is after a stock dividend had been declared.)

It will be observed that (2) last shown is identical with (5) next preceding. As in (5) the additional amount of stock is supported by the increase in actual cash value of the ore lands, so in (2) last above the additional stock is so supported, —no more in one case than the other.

Sub-Point 7.

If it should be assumed that it was not the intention of Congress to have included as a part of the invested capital of a corporation an appreciation in the value of its property over cost, where such excess value has not been applied to the payment for additional stock, it does not follow that such appreciation should not be allowed, up to the actual value of the property (not in excess of the par value of the stock), where such application has been made.

Reference is made to what has been said under sub-points 1 to 6.

The amount of the appreciation is, by the stock dividend, definitely ascertained and capitalized with certain necessary consequences:

(a) It is the public policy of all the states that stock shall not be issued as fully paid up

unless there is property supporting it worth the amount of the capital stock after all debts have been paid. In many of the states there are statutory requirements that before an amendment may be filed authorizing an increase of the capital stock, evidence, *under oath,* satisfactory to them, shall be furnished the administrative officers showing that money or property has been paid in to the corporation in an amount equal to the proposed new issue. These apply as well to an increase of stock by a stock dividend as to an increase by a sale for cash or property.

(b) A definite election as to liability is made by the stockholders when they consent to the declaration and payment of such a stock dividend. They, in effect, by the acceptance and continued ownership of the new stock warrant to creditors of the corporation, present, and prospective, that the stock at the time of the issuance thereof is supported by assets, taken at their fair value, in an amount equal to the entire outstanding stock plus the liabilities of the corporation. Having accepted such stock, they become liable, should the corporation prove insolvent, to the extent of the deficiency in such assets, if any there should have been.

(c) Having elected to convert what was before "surplus" into "capital stock," the stockholders take from the directors the power to pay cash or other dividends to the extent previously enjoyed by them. Since such divi-

dends can be paid out of *"surplus"* only, this power is withdrawn to the extent that "surplus" is diminished.

Respectfully submitted,

JESSE ANDREWS,
Solicitor for The Long-Bell Lumber Co.

Washington, D. C., Dec. 15, 1920.

No. 468.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1920.

LA BELLE IRON WORKS, APPELLANT,

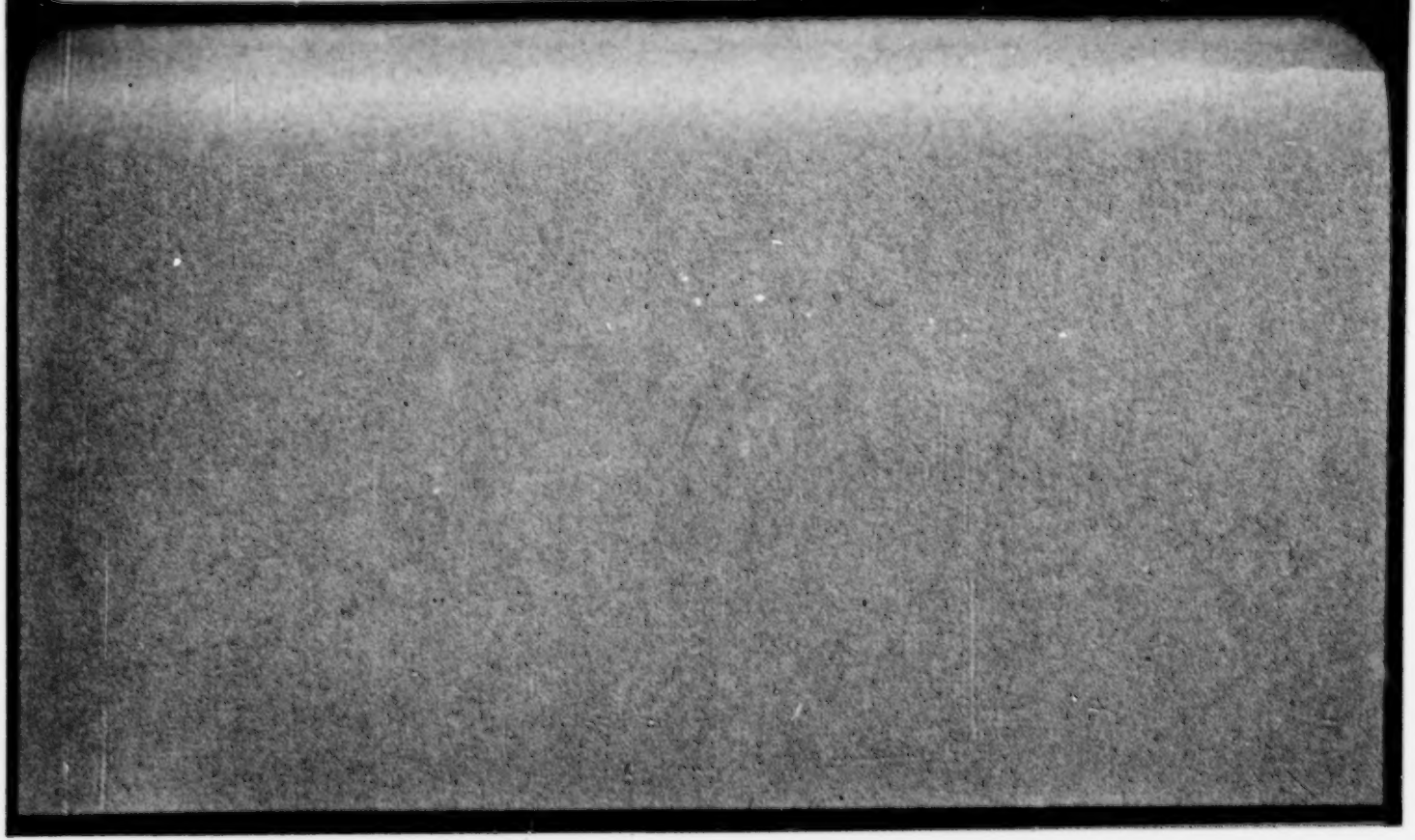
VS.

THE UNITED STATES, APPELLEE.

APPEAL FROM THE COURT OF CLAIMS.

BRIEF OF KANSAS CITY STRUCTURAL STEEL COMPANY, AMICUS CURIAE.

ARMWELL L. COOPER,
ELLISON A. NEEL,
JOHN S. WRIGHT,
Counsel.



No. 453.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1920.

LA BELLE IRON WORKS, APPELLANT,

VS.

THE UNITED STATES, APPELLEE.

APPEAL FROM THE COURT OF CLAIMS.

BRIEF OF KANSAS CITY STRUCTURAL STEEL COMPANY, AMICUS CURIAE.

This is an appeal (Rec. 14) from a judgment of dismissal entered by the Court of Claims (id.) upon a demurrer (Rec. 13) to the plaintiff's petition (Rec. 1-12), a full statement as to which has been made by the National Lumber Manufacturers' Association, which has been permitted to file herein a printed argument.

The Kansas City Structural Steel Company is not a member of that association. Yet, it is, and has been since prior to January 1, 1917, engaged in an extensive manufacturing business at Kansas City, Missouri. A large portion of its capital assets consist of specific, well defined increases in value, familiarly known as "appreciation." It is, therefore, vitally interested in the questions herein involved. Its counsel have been accorded the privilege of fully conferring with and assisting counsel for said association in the preparation of their argument. Having fully incorporated therein its own views, therefore, instead of filing a separate brief, the Kansas City Structural Steel Company, *amicus curiae*, joins in that argument and adopts it as presenting its views.

Respectfully submitted,

ARMWELL L. COOPER,
ELLISON A. NEEL,
JOHN S. WRIGHT,
Attorneys for Kansas City Structural Steel Company.

Kansas City, Mo., December 24, 1920.

FILED
JAN 3 1921
JAMES D. MAHER,
CLERK.

No. 453

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1920.

LA BELLE IRON WORKS, a corporation,
Appellant,

vs.

UNITED STATES,
Appellee.

APPEAL FROM THE COURT OF CLAIMS.

BRIEF OF CLARENCE N. GOODWIN FILED BY LEAVE OF COURT AS AMICUS CURIAE.

DUNLOP-WORDEN PRINTING COMPANY, CHICAGO.

IN THE

Supreme Court of the United States.

OCTOBER TERM, 1920.

LA BELLE IRON WORKS, a corporation,
Appellant,

vs.

UNITED STATES,
Appellee.

APPEAL FROM THE COURT OF CLAIMS.

BRIEF OF CLARENCE N. GOODWIN FILED BY LEAVE OF COURT AS AMICUS CURIAE.

MAY IT PLEASE THE COURT:

In addition to other items of invested capital Section 207 provides that there shall be included

> (3) paid in or earned surplus and undivided profits used or employed in the business exclusive of undivided profits earned during the taxable year.

It is suggested that the words "paid in or earned surplus and undivided profits used or employed in the business" clearly state an intention to include in the computation of invested capital all capital actually employed, and to exact excess profits taxes only on those profits which are in excess of a fair return on such capital.

The paragraph in question enumerates three specific items of investment which are to be considered in addition to the items of paid in capital enumerated in (1) and (2). As three distinct items are enumerated, it is clear that the Congress recognized that each item had characteristics which distinguished it from each of the other items.

The Treasury Department has recognized that "paid in surplus" means exactly what it says, money or *property*, or both, paid into the corporation, and having a value in excess of the capital stock issued therefor;[1] while its interpretation of "undivided profits" confines that term to profits actually realized in money and such equivalents as bills or accounts receivable.

This construction of the statute by the department gives no significance to the words, "earned surplus" but attempts to assimilate those words with the words "undivided profits."

Our courts, however, have uniformly adopted the very sensible rule, stated by Lord Coke, to the effect that:

> "The good expositor makes every sentence have its operation; gives effect to every word; will not

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[1] **Treasury Department Regulations No. 41, Relative to War Excess Profits Tax, Article 63.**

When tangible property may be included in surplus. Where it can be shown by evidence satisfactory to the Commissioner of Internal Revenue that tangible property has been conveyed to a corporation or partnership by gift or at a value, accurately ascertainable or definitely known as at the date of conveyance, clearly and substantially in excess of the cash or the par value of the stock or shares paid therefor, then the amount of the excess shall be deemed to be paid in surplus. The adopted value shall not cover mineral deposits or other properties discovered or developed after the date of conveyance, but shall be confined to the value accurately ascertainable or definitely known at that time.

construe it so that anything shall be in vain or superfluous."[2]

In stating the same rule in *Commonwealth* v. *McCaughy*, 9 Gray (Mass.), 296, the court said, at page 297:

> "For it is an anciently established rule in the interpretation of statutes that such a sense is to be made upon the whole statute that no clause, sentence or word shall prove superfluous, void or insignificant if by any other interpretation they may all be made useful and pertinent. 1 Show. 108; Bac. Ab. Statute, I. 2."[3]

The soundness of this rule is affirmed by this court in *Montclair* v. *Ramsdell*, 107 U. S. 147, where Mr. Justice Harlan, speaking for the court, said, at page 152:

> "It is the duty of the court to give effect, if possible, to every clause and word of the statute, avoiding if it may be, any construction which implies that the legislature was ignorant of the meaning of the language it employed"[4]

The defendant's interpretation, however, rejects the words, "earned surplus," as absolutely without significance, and, in so doing, imposes upon them a meaning which is opposed to what counsel for appellant has shown to be their generally accepted meaning, and contrary to the very thought naturally expressed by the words themselves. If it is true that when we think of profit, we or-

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[2] Fertest v. The People, 65 Ill. 233.
729.
Wendler v. Taylor (Kans.), 18 Pac. 911.
Nichols v. Wells, 2 Ky. (Ky. Dec.), 255.
Opinion of Justices, 22 Pickering, 571.
Brown v. Turner (Mass.), 54 N. E. Reporter, 510, 514.
State v. Harden (W. Va.), 58 S. E. Reporter, 728.

[3] To the same effect, see opinion of Hornblower, C. J., in Den, etc. v. Dubois, 16 N. J. Law Reports, 292, at 293.
Hawkins v. Louisville etc. R. Company (Ala.), 40 Southern, 296.

[4] Cited in Whalen v. N. York, etc. Railway Company, 35 Fed. 855.
In re Thorpe, 130 Fed. 376.

dinarily think of something realized in the form of money or its equivalent, it is equally true that when we think of surplus, we think of values and specifically we think of value in excess of some definite amount. This is not merely a general interpretation of the word "surplus," but is, in fact, the interpretation placed upon it by the government in Regulations 41, Article 63, already quoted in note 1, where the Treasury Department specifically recognizes that the words "paid in surplus" include an overplus in value of *property* turned over to the corporation although the words "*paid in*" are far more indicative of *money* than the word "*earned.*"

In other words, we find that the government holds that the words "*paid in* surplus" include an excess in the *value of property* over and above the stock issued for it while the expression "*earned* surplus" is strictly confined to earnings which have been transformed into money or its equivalent.

Such interpretation is clearly analogous to those gentle processes by which persons of unpopular religious beliefs were at one time made to fit with absolute exactness into beds very illy suited to their stature.

The plain meaning of the words of the statute when given their full force and effect, operate justly and equally on all corporations, irrespective of the accidental incidents of their incorporation and organization, while the interpretation placed on the words by the bureau results in a monstrous inequality in the taxation of different corporations having identically the same capital and differing only in such matters as the amount for which they were capitalized (the bureau's interpretation favoring those companies that have used water liberally and penalizing those that have been conservative), and in such purely immaterial particulars as whether

there had been or had not been a reorganization prior to a certain date or whether there had or had not been transfers of a whole or part of the property.

If the Government is to rely on practical construction it is suggested:

1. During the year in which returns were required to be filed under this (1917) law, the Department made no plain ruling to the effect that earned surplus not converted into money was to be excluded; the Department's rulings on the subject of invested capital being far more in need of analysis and interpretation than the statute.

2. As a rule taxpayers who were entitled to claim earned surplus as interpreted by appellant have included it in their return, and the question only arises on re-assessments.

3. Where taxpayers having earned surplus were advised of the position of the Government, they did not in general acquiesce in that rule.

It is to be remembered that on account of the methods of incorporation ordinarily pursued, corporations were not, in general, in a position to claim "earned surplus" in the year 1917.

As there has been no general acquiescence in the position of the Bureau of Internal Revenue, there has been no practical construction of the words in question.

It is respectfully suggested that if the words "earned surplus" are recognized and given their natural meaning the only effect of such judicial action will be to restore justice and create equality of taxation.

The government has certain large obligations which must be discharged. The wealth, resource, and income of the Nation are amply sufficient to provide for the necessities of the government and the discharge of its obliga-

tions. If the government has, through faulty construction of the statute taken from some taxpayers larger amounts in taxes than the statute justifies, then those taxpayers upon presenting their claim, and demonstrating that fact in some such manner as the Treasury Department has outlined in the Regulation quoted in note 1, will be entitled to credits or refunds to the extent of their respective overpayments, and the only effect will be that those amounts when finally ascertained will be reflected in the taxes required in subsequent years. This would impose no additional burden on the government as it makes a field audit of every return for each taxable year.

In brief, the only practical effect of a decision giving the language of the statute its natural scope, will be to wipe out a construction which makes the statute an arbitrary levy accompanied by most unhappy evidences of inequality and injustice, and by restoring the natural meaning of the words used, to make the statute what it was intended to be, viz.: a mode of taxation which treats all taxpayers exactly alike and confines the tax to profits in excess of a fair return on the capital actually employed.

It may, however, have the further effect of retaining in our revenue system a salutary principle of taxation which the many injustices resulting from the bureau's interpretation have made almost universally discredited.

Respectfully,

CLARENCE N. GOODWIN,
Appearing as Amicus Curiae.

JAN 3 1921
JAMES D. MAHER,
CLERK.

IN THE

SUPREME COURT

OF THE

UNITED STATES.

October Term, 1920.

No. 453.

La Belle Iron Works,
Appellant,

vs.

The United States,
Appellee.

Brief on Behalf of H. C. Capwell Co. Amicus Curiae.

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IN THE

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October Term, 1920.

No. 453.

La Belle Iron Works,
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Brief on Behalf of H. C. Capwell Co. Amicus Curiae.

This corporation on behalf of which this brief is filed is vitally interested in the questions decided by the Court of Claims in the above action, and will necessarily be greatly prejudiced if the ruling of the Court of Claims is allowed to stand. The consent of the appellant in this case has been obtained to the filing of this brief as *amicus curiae.*

STATEMENT.

The question involved in this case is an interpretation of the meaning of "earned surplus" and "undivided profits," as used in Act of October 3, 1917, known as the War Excess Profits

Tax. (Chap. 63, 40 Stat. at L., Sec. 207; Comp. St., Sec. 6336 3/8h.)

The facts are that appellant purchased land, for cash, in 1904 and thereafter discovered minerals on said land which increased the value greatly, all of which took place prior to March 1, 1913, and it is the contention of appellant that this increase in value is a part of its earned surplus and undivided profits.

The First Point to Be Decided Is What Is Profit or Surplus.

A leading English case on the subject of what constitutes profits, analyzes the entire subject and after careful study defines "profits" as including any increase in value whenever earned, regardless of whether the property is sold or the profits otherwise realized.

The point at issue in this case was a determination of what are the actual profits of a corporation, out of which the salaries of the officials conducting the business were to be paid.

> "The question for our decision in the present case is of some general interest, because it turns upon the legal meaning of the word 'profits,' and inasmuch as I believe that the decision of the learned judge in the court is erroneous, and that uncertainty or error in so fundamental matter may lead to serious confusion, I shall in the first place consider the general question and then proceed to deal with the special facts of the case.

"The word 'profits' has in my opinion a well-defined legal meaning, and this meaning coincides with the fundamental conception of profits in general parlance, although in mercantile phraseology the word may at times bear meanings indicated by the special context which deviate in some respects from this fundamental signification. 'Profits' implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.

"For practical purposes these assets in calculating profits must be valued and not merely enumerated. An enumeration might be of little value. Even if the assets were identical at the two periods it would by no means follow that there had been neither gain nor loss, because the market value—the value in exchange—of these assets might have altered greatly in the meanwhile."

In re Spanish Prospecting Co., Limited (1911), 1 Ch. Div. 92, 98-9, 20 Am. & Eng. Ann. Cas. 677, 679.

The notes to the above to be found in the American & English Annotated Cases, are very elaborate and illuminating.

"Profits do not necessarily imply money to be divided; they may be represented by the unsold portion of property which was the subject of the speculation."

Jones v. Davis, 48 N. J. Eq. 493, 499.

"Difference between assets and liabilities, including good will, is profit."

Washburn v. National Wall Paper Co., 81 Fed. Rep. 17.

The net value of a corporation's assets is always regarded as surplus profits.

Williams v. Western Union Tel. Co., 93 N. Y. 162, 188-9;

Thurston v. Hamblin, 199 Mass. 151, 158;

Stein v. Strathmore, 221 Mass. 86, 88-9;

Pottsford v. Van Ripper, 33 Nev. 156, 195;

Little Miami etc. R. R. Co. v. U. S., 100 U. S. 277, 279;

Brainard v. Hubbard, 12 Wall. 1, 18.

Doctrine Announced by This Court.

In a series of decisions rendered by this court in cases involving interpretations of the income tax laws, the court has held that any increase in the value of property not sold is not income, but, as a necessary part of these decisions, this court has distinguished between "income" and "profits" which result in increase of capital.

"We perceive no adequate ground for distinction, in this regard, between an accumulation of surplus earnings and the increment due to an appreciation in value of the assets of the taxpayer."

Southern Pacific Co. v. Lowe, 247 U. S. 330, 335, 62 L. ed. 1142.

"Mere advance in value in no sense constitutes gains, profits or income, as specified by the statute. It constitutes and can be treated merely as increase of capital."

Gray v. Darlington, 15 Wallace 63-65, 21 L. ed. 45.

Cited with approval in Lynch v. Turrish, 247 U. S. 221, 230.

"This case has not been since questioned or modified."

247 U. S. 230, 62 L. ed. 1093.

"When the act took effect, plaintiff's timber lands, with whatever value they then possessed, were a part of its capital assets."

Doyle v. Mitchell Bros., 247 U. S. 179, 187, 62 L. ed. 1054.

"It then means the property taken from other investments or uses and set apart for and invested in the special business, and in the increase, proceeds or earnigs of which property, beyond expenditures incurred in its use, consist the profits made in the business."

Bailey v. Clark, 21 Wallace 284-287, 22 L. ed. 651.

Surplus may include either past earnings or increase in value of assets.

Lynch v. Hornby, 247 U. S. 339, 62 L. ed. 1149.

The Same Doctrine Has Been Announced by Other Federal Courts.

> "The act contemplates an estimation of income and of deductions therefrom upon a 'cash,' as opposed to a 'revenue' basis. * * * Appreciation in value of securities thus held does not become income until it is received by realization."
>
> Lumber Mut. Fire Ins. Co. v. Malley, 256 Fed. Rep. 383, 384.

Premium on bonds and other increments of value held to be undivided profits and cannot be distinguished from surplus.

> Leather Mfgrs.' Natl. Bank v. Treat, 128 Fed. Rep. 262;
>
> Mercer v. Buchanan, 62 C. C. A. 644, 132 Fed. Rep. 501.

Certiorari denied.

> 198 U. S. 584, 49 L. ed. 473.

There Is a Difference Between "Earned Profits" and "Realized Profits" As There Is Between "Income" and "Profits."

To determine the true meaning of the phrase "earned surplus" and "undivided profits" as used in the Internal Revenue Law of 1917, we must determine what Congress meant by the word "earned."

A well known authority on the question of accounting, as well as income tax law, Mr. Robt. H. Montgomery, has said:

"A very clear distinction must be made at the outset between 'profits earned' and 'profits realized.' The term 'earn' means to reap, and is derived from an ancient root meaning *to plow*. There is no suggestion of money in the word, which clearly implies that corn once harvested must be considered as earnings, or something gained by labor. And the principle of including, as profits, earnings that have not been received in the form of money has for centuries been accepted in trade. The division of profits (as dividends), however, must result only when the earnings have been made tangible, if not actually rendered into cash in hand."

The American Business Manual, by Robt. H. Montgomery, Volume 3, Administration, chapter XXVII, page 999.

Other accounting experts have expressed opinions on the subject of profits due to appreciation in the value of assets unsold.

Profits due to appreciation should be accounted for in the reserve and surplus accounts.

Mucklow's Real Estate Accounts (1917), page 137, paragraph 107; also page 135, paragraph 105.

"Surplus is sometimes the result of a direct acquisition of value not belonging to the fiscal period or to the opening of business, as an increase in value of real estate, of investments, or of other assets of a permanent nature."

Bennett Corporation Accounting (Ninth Printing 1919), page 336.

This court has very clearly stated the distinction between the "income" taxable under the law and "profits," by defining the difference between income "derived from capital" and a gain "accruing to capital."

Eisner v. Macomber, 252 U. S. 189.

Congress undoubtedly had in mind the distinction between income and profits when this act was passed. In the act Congress repeatedly refers to "income" as being the gauge of the tax and this court has defined the limitations of Congress under the constitutional amendment of 1913. Under this amendment Congress cannot impose a tax upon anything except income derived from property notwithstanding the fact that it might be a profit. See Eisner v. Macomber, *supra*, and ather cases above cited.

In the drafting of section 207 of the Act of 1917, Congress was defining what particular items might be used by a corporation in determining the amount of deduction which they would be allowed before paying a portion of their income tax.

In the determination of what this deduction should be, there was no constitutional limitation upon Congress and therefore when the word "profits" is used in that section, its meaning is not confined to income.

When Congress preceded the word "profits" by the word "earned," they must have had in

mind the distinction between the word "earned" and the word "realized," as well as the distinction between the words "earned profits" and "income."

It has been recognized uniformly that an earned profit does not necessarily mean income, nor does it mean that the profit has been realized, but on the contrary the words "earned surplus and undivided profits" are all inclusive and take in every kind and nature of profit, being limited only by the additional words in the law, "used or employed in the business, exclusive of undivided profits earned during the taxable year."

In using the words "surplus and undivided profits" Congress has made it definite that this item must be something over and above the liabilities, that is to say, earned surplus and undivided profits used or employed in the business means the excess left in the business after paying all expenses of the business and deducting all depreciations and reductions of value that have previously taken place.

Congress chose to define invested capital as including cash paid in for stock or the value of any tangible property paid in for stock (as limited), and in addition to these items any surplus paid in by the stockholders *and* any surplus or profits earned by the corporation and not distributed to the stockholders, whether realized as the result of a sale or otherwise.

In the use of the words "paid in or earned surplus," Congress may or may not have intended these words to apply to the undivided profits, for paid in undivided profits are an unknown thing in commerce, and therefore we must distinguish between "paid in and earned surplus" and "undivided profits," each of which is cumulative and none limiting the intent of Congress.

Earned surplus and profits have been recognized for centuries as being the total net value of all of the assets over and above the amount which is paid in by the stockholders, and it therefore appears clear that when Congress, being unlimited in their power, chooses to use language which clearly and fairly includes any increase in value, it was not their intention that the law should be construed to limit this item to a realized profit or to profits or surplus which had previously become "income."

The Contentions of the Government.

The position of the Government is well stated in a very brief outline, quoting from the Committee on Appeals and Reviews:

> "The committee is of the opinion that appreciation is in no event a part of earned surplus and therefore cannot offset depreciation in the value of assets through wear, tear, and exhaustion. Depreciation must first be figured in order to determine true earned surplus. In other words, earned

surplus is believed to consist of realized gains or profits, and while such realized gains or profits must be reduced by any depreciation in value through use or exhaustion of the assets in which they are invested, any appreciation in value of those assets which is not yet realized cannot be taken into consideration for the purpose of offsetting such decrease."

Digest of Income Tax Rulings, No. 11, August, 1920. Issued by The Treasury Department, Bureau of Int. Rev., page 274; 18-20-906. A. R. R. 71.

This statement of the contentions of the Government is a succinct wording of the interpretation which the Treasury Department has attempted to read into the Act of 1917 in applying section 207 of said act to income and war excess profit taxes due the Government. (Chap. 63, Sec. 207, 40 Stat. at L.; Comp. St., Sec. 6336 3/8h.)

To state the stand taken by the Bureau of Internal Revenue is a sufficient answer, for on its face it is very apparently incorrect and contradictory.

"It illustrates the not unnatural tendency of tax officers to increase the revenues by implications and strained constructions."

First Trust & Savings Bank v. Smeitanka, decided U. S. Circuit Court of Appeals, Seventh Circuit, October term and session, 1920. Not yet reported.

"No usage can prevail against the clear and unambiguous terms of the law. The collector is but a mere ministerial officer. It may be his misfortune, or the misfortune of the public, that he misinterprets the law; but certainly he cannot alter it."

U. S. v. Lyman, 1 Mason (C. C.) 481, 504.

See also:

U. S. v. Watts, 1 Bond (U. S. C. C.) 580, 583;

Federal Cases No. 16,653.

Subdivision A of section 207 (Chap. 63, 40 Stat. at L. 306, Comp. St. 1918, Sec. 6336 3/8h) reads as follows:

"(a) In the case of a corporation or partnership:

"(1) Actual cash paid in,

"(2) The actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), *and*

"(3) Paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year." (Italics ours.)

A fact of which the court should take judicial notice is the manner in which the Treasury Department are attempting to interpret this law.

The corporation at bar purchased property for $190,000 and thereafter this property became worth $10,000,000. The treasury Department have contended, in similar cases, that should this corporation sell an undivided one-half interest in this property for five million dollars cash, in the year 1916, it would be permitted to use $4,995,000 of profit as part of its invested capital in 1917, but the additional $4,995,000 of profit remaining in the unsold property could not be considered as a portion of its invested capital because it had not yet been converted into cash. This is the ruling which the Treasury Department is asking this court to read into this law as an interpretation of its meaning.

The Treasury Department, and the court below, appear to have overlooked or to have ignored the word "and," italicized above and appearing at the end of the second subdivision of paragraph (a) of section 207, and to the fact that the augmenting "and" does not appear at the end of the first subdivision after the words "actual cash paid in."

The intent of Congress in this case appears clear from a careful reading of the act. For example, if, prior to January 1, 1914, a corporation sells one million dollars of stock at par

and receives in payment therefor part cash and part tangible property other than cash, which property is worth the actual par value of the stock, and thereafter should sustain losses in business or depreciation in the assets of the corporation, either by physical wear and tear or otherwise, they would at all times thereafter be deemed to have had one million dollars invested capital.

The Government admits that if the same property were paid in for stock after January 1, 1914, the entire value of the property on the date paid in would be invested capital, without regard to the par value of the stock, and the invested capital would not be subject to reduction by future losses.

Some argument has been made by the Government that on account of these facts, Congress intended to limit the third subdivision of the section so that any property of the corporation must be considered as invested capital; (a) if acquired prior to January 1, 1914, to the value on that date not to exceed the par value of the stock, and (b) if acquired after that date, to the value of the property when acquired, and that any future increase could not be considered, but decreases must be considered.

Subdivisions "1" and "2" of the section in question merely define what the stock shall be taken in at in determining the invested capital.

If cash is paid in, then there is no question; if property is paid in before January 1, 1914, then its value on that date is the value to be considered regardless of the value when acquired; and if property is paid in after that date, it is capital up to what it is worth.

All this is clear and reasonable as indicating what went into the business from the stockholders directly.

Because Congress took into consideration the fact that property paid in for stock might be difficult of reduction to a cash basis, and defined how that should be done, does not in any way alter the fact that other increases might also occur which would increase the profits; but merely made it clear that in so far as determining the value of the stock or share capital is concerned there would be no doubts.

If There Is Doubt the Law Should Be Construed in Favor of the Taxpayer.

"The liability of an instrument to a stamp, as well as the amount of such duty, is determined by the form and face of the instrument and cannot be effected by proof outside of the instrument itself. If there is a doubt as to the liability of an instrument to taxation, the construction is in favor of the exemption."

U. S. v. Ishiam, 17 Wall. 496, 504, 21 L. ed. 728, 730;

Equitable Trust Co. v. Seldon, Federal Cases No. 4508.

Affirmed

Selden v. Equitable Trust Co., 94 U. S. 419, 24 L. ed. 249, 250.

"The words used are not technical. They are, therefore, to be used in their common and popular sense. Dwarris Statutes, 573."

Id. 94 U. S. 421.

"It is a fundamental duty of the law-givers to make the scope of a tax-law definite and its meaning clear; and therefore all doubts respecting scope and meaning are to be resolved in favor of the taxpayer."

First Trust & Savings Bank v. Smeitanka, Circuit Court of Appeals, Seventh District, Oct. term, 1920. Not yet reported.

Citing

Gould v. Gould, 245 U. S. 151, and

Treat v. White, 181 U. S. 264.

The Present Case Does Not Come Under These Provisions.

The property brought in question in the present case does not come within the terms of the first and second subdivisions of paragraph (a) of section 207 of the Act of 1917. This is not property paid in for stock, and, therefore, in the present case it is not necessary for the court to decide what is included within the first two subdivisions of this section. The property in

the present case was purchased for cash and can only be considered under the third subdivision of the section quoted.

If a corporation should lose money, this loss could in no way reduce the amount actually paid in by the stockholders, and, therefore, no losses or depreciations could reduce the capital invested.

On the contrary, should they make profits and not withdraw them from the business, they would increase the amount they had invested, but there would be no increase if previous losses exceeded future gains. Therefore, all gains must be first charged against previous losses before there is an earned surplus or undivided profit used or employed in the business.

Whenever the profits become greater than any previous losses then the surplus exists.

In Defining the Deductions to Be Allowed in Determining the Net Income Under the Act of 1917, Congress Has Recognized the Above Principles.

In the Act of Sept. 8, 1916, Ch. 463 Sec. 12 (a), Second, (b), 39 Stat. at large 768, not amended in the Act of October 3, 1917 (Chap. 63, Sec. 1207, 40 Stat. 334, 335; Comp. Stat. 1918, Sec. 6336d), it is provided:

> "In the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product

> thereof, which has been mined and sold during the year for which the return and computation are made, * * * *provided that when the allowances authorized in (A) and (B) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made.*" (Italics ours.)

Congress has here recognized the established principle that profits resulting from appreciation prior to 1913 cannot be made subject to tax although realized afterwards by sale, but on that date were a part of the capital of the taxpayer and are therefore subject to depletion in determining profits realized after 1913.

Conclusions.

When Congress drafted this law they had clearly in mind the constitutional limitation in connection with their definition of income and when section 207 was drafted they had in mind the fact that there was no constitutional limitation in their determination of what should constitute the invested capital on which the deduction and graduated taxes should be based. In various parts of this same law Congress saw fit to use the word "income," while in drafting section 207 this word does not appear. On the contrary they selected language which clearly is all inclusive and is in no way limited to either

income or realized profits but which clearly defines in language well known to business, the net amount resulting to the taxpayer at the end of any period without regard to whether he has ever received it in cash or whether it has become income, or has been realized in any other manner.

When the Treasury Department attempted to read into this law an interpretation of this section which would apply the constitutional limitation as to what is taxable to the provisions of the law applying to what could be deducted before determining what was taxable, they were going outside the clear meaning of the section.

Respectfully submitted,

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In the Supreme Court of the United States.

OCTOBER TERM, 1920.

LA BELLE IRON WORKS, APPELLANT,
v.
THE UNITED STATES.

No. 453.

APPEAL FROM THE COURT OF CLAIMS.

BRIEF FOR THE UNITED STATES.

This case comes from the Court of Claims. It is a suit to recover money alleged to have been illegally collected as war excess profits taxes under Title II of the revenue act of October 3, 1917 (40 Stat., c. 63, pp. 300, 303), which, in addition to the ordinary income taxes, imposes a further tax upon the income of every corporation, partnership, or individual after deducting therefrom a certain per centum of the invested capital.

STATUTE INVOLVED.

Under the head "War excess profits tax," the act of October 3, 1917, after imposing certain income taxes, imposed, by section 201, an additional income tax on income derived from trades or businesses as follows:

> That in addition to the taxes under existing law and under this act there shall be levied,

> assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income: * * *.

The tax thus imposed is graded. It begins with:

> Twenty per centum of the amount of the net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year.

The rate gradually increases until it reaches—

> Sixty per centum of the amount of the net income in excess of thirty-three per centum of such capital.

To illustrate: If a taxpayer's invested capital is $100,000, and his net income, after making the deduction, is $50,000, his tax is as follows:

20 per cent of the first $15,000, or	$3,000
25 per cent of the next $5,000 or	1,250
35 per cent of the next $5,000, or	1,750
45 per cent of the next $8,000, or	3,600
60 per cent of the remaining $17,000, or	10,200
Total	$19,800

Thus the tax is imposed upon the net income after making the allowed deduction, and the rate is determined by the ratio of the taxable income to the invested capital. It applies to "all trades or businesses of whatsoever description," with certain exceptions not now necessary to mention.

The deduction which is to be based on invested capital is set out in section 203, which, so far as now pertinent, is as follows:

> That for the purposes of this title the deduction shall be as follows, except as otherwise in this title provided—
>
> (*a*) In the case of a domestic corporation, the sum of (1) an amount equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the prewar period was of the invested capital for the prewar period (but not less than seven or more than nine per centum of the invested capital for the taxable year), and (2) $3,000; * * *.

Section 200 defines the prewar period as the calendar years 1911, 1912, and 1913. And the general scheme of the act is to impose the tax upon net incomes after deducting an amount equal to the same percentage of the invested capital for the taxable year which the taxpayer had during the prewar period realized upon his then invested capital, with a provision, however, that the deduction allowed shall, in no event, be less than seven nor more than nine per centum of the invested capital for the taxable year.

Since both the rate of taxation and the amount of the deduction must be determined by reference to invested capital, special attention is called to section 207, which, so far as pertinent, is as follows:

> As used in this title, "invested capital" does not include stocks, bonds (other than

obligations of the United States), or other assets the income from which is not subject to the tax imposed by this title, nor money or other property borrowed, and means, subject to the above limitations:

(*a*) In the case of a corporation or partnership: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid-in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year: *Provided*, That (*a*) the actual cash value of patents and copyrights paid in for stock or shares in such corporation or partnership, at the time of such payment, shall be included as invested capital, but not to exceed the par value of such stock or shares at the time of such payment, and (*b*) the good will, trade-marks, trade brands, the franchise of a corporation or partnership, or other intangible property, shall be included as invested capital if the corporation or partnership made payment bona fide therefor specifically as such in cash or tangible property, the value of such good will, trade-mark, trade brand, franchise, or intangible property not

> to exceed the actual cash or actual cash value of the tangible property paid therefor at the time of such payment; but good will, trademarks, trade brands, franchise of a corporation or partnership, or other intangible property, bona fide purchased, prior to March third, nineteen hundred and seventeen, for and with interests or shares in a partnership or for and with shares in the capital stock of a corporation (issued prior to March third, nineteen hundred and seventeen), in an amount not to exceed, on March third, nineteen hundred and seventeen, twenty per centum of the total interests or shares in the partnership or of the total shares of the capital stock of the corporation, shall be included in invested capital at a value not to exceed the actual cash value at the time of such purchase, and in case of issue of stock therefor not to exceed the par value of such stock; * * *.

In the computation of the tax of a corporation it is necessary to ascertain the amount of the "invested capital" (1) during the prewar period and (2) during the taxable year. And invested capital, for both purposes, is, in general and with certain limitations, defined as including (1) the amount paid in, either in cash or in property, for stock or shares and (2) the amount of surplus and undivided profits either *paid in or earned* and used or employed in the business.

THE FACTS.

Appellant, a domestic corporation, owned, during 1917, certain ore lands. These lands had not been

received by it in payment of its shares of stock. It had acquired them prior to 1904 by investing in their purchase $190,000. Subsequently, they were found to contain such valuable bodies of ore that, in 1912 and ever since, they have been worth not less than $10,105,400. The company, however, did not sell them and take the profit it might have realized by such a sale. It merely increased their valuation on its books by adding to the previous valuation of $190,000 the sum of $10,000,000 in 1912 and carried that sum to surplus. It then amended its charter so as to increase its authorized capital stock from $9,915,400 to $20,000,000. divided equally into common and preferred stock, and declared a stock dividend in the sum of $9,915,400 to represent increase in the value of these ore lands. All the original certificates of stock were then surrendered and, for each share so surrendered, the stockholder received, in exchange, one share of the new common stock and one share of the new preferred stock.

Appellant made its tax returns for 1917. In doing so, it computed its invested capital for that year to be $26,322,907.14, from which it deducted 7 per cent and paid a war excess-profits tax of $5,139,109.84. In this computation, it included $9,915,400 which represented the increase in value of the ore lands and had itself, since 1912, been represented by the stock issued as a stock dividend. Later, when the returns were examined, the Commissioner of Internal Revenue ruled that this sum of $9,915,400 could not properly be included in invested

capital and made an additional assessment upon which appellant paid, under protest, an additional war excess-profits tax of $1,081,184.64. After taking the necessary steps to entitle it to sue, it brought the present suit to recover the latter amount.

RULING OF THE COURT.

The facts above stated being fully set out in the petition, the Court of Claims sustained a demurrer and dismissed the case.

QUESTION INVOLVED.

The question is whether the mere increase in the value of lands previously purchased and still owned by a corporation is invested capital within the meaning of the act of Congress.

THE OPPOSING CONTENTIONS.

The appellant's theory is that the capital invested in its ore lands is not what it paid for them but is to be measured by the present value of the lands and that, therefore, the full value of these lands must be treated as a part of the invested capital upon which the deduction is to be based.

The Government contends, on the other hand, that the act clearly defines the "invested capital" as the amount received in exchange for its shares of stock plus any "paid in or earned surplus" used in its business; that appellant invested in the purchase of these lands only $190,000, and, no matter how long it holds them or how much their value may fluctuate, that sum remains the amount of capital

invested in them; and that paid in or earned surplus and undivided profits do not include the unearned increment arising from the mere holding of lands until they increase in value, or the potential but unrealized profits which would accrue on the investment if the owner should choose to sell.

These contentions make the concrete issue—is the deduction to be based upon the amount of capital which the corporation has invested, or upon the value, at a particular time, of the property in which that capital has been invested?

BRIEF.

I.

The war excess-profits tax is one of three income taxes imposed on corporate earnings so imposed that each tax is paid either by the corporation or the stockholders, but never by both.

There are three income taxes which reach corporate earnings—the normal tax, the additional or surtax, and the war excess-profits tax. But no one of them is imposed both upon such earnings in the hands of the corporation and upon dividends when received by the stockholders.

The normal tax is imposed upon both corporations and individuals, but a stockholder receiving a dividend from a corporation which is subject to the tax is not required to include it as a part of his taxable income.

The additional or surtax is a graded tax imposed upon large incomes. It is not imposed upon cor-

porations, and, for its purposes, individual stockholders must include dividends received from corporations as a part of their taxable incomes. Corporate earnings, therefore, are not subject to this tax except as, through dividends, they become a part of the incomes of individual stockholders, and are then taxed at a rate depending upon the aggregate amount of the income of which they become a part.

The war excess-profits tax is imposed upon the income of both corporations and individuals. But again the individual stockholder is not required, for the purposes of this tax, to include dividends received from corporations subject to the tax as a part of his taxable income.

II.

The tax in question is not a pure war excess profits tax, but rather a tax on incomes after deducting what Congress determined would be a fair return on capital invested during the war.

Undoubtedly, the primary purpose of Congress in levying this tax was to lay a heavy hand on all abnormal profits which came as the result of opportunities for money making brought about by the war itself. But the tax, as imposed, is not a pure war excess profits tax. Many corporation were accustomed during the prewar period to earn a much higher rate of profit on their investments than that which is exempt from this tax. The necessities of the Government made it proper that those receiving

a large return upon investments should pay taxes at a higher rate than those receiving returns at a lower rate, even though the former might not be traceable directly to war conditions. It was also deemed fair that some return should be allowed before imposing this unusual tax.

It was, therefore, provided that each taxpayer should be allowed the same rate of profit derived during the prewar period with the further provision that the percentage allowed should, in no case, be less than 7 per cent nor more than 9 per cent of the invested capital. The result is that every taxpayer is to be allowed a deduction of at least 7 per cent, and may be allowed as much as 9 per cent if that does not exceed the rate of profit which prevailed before the war. The tax, in the last analysis, therefore, is a tax upon net incomes after deducting what Congress determined would be a fair return upon the invested capital.

If a corporation had, before the war, an invested capital of $100,000 on which it was accustomed to earn 8 per cent, or $8,000, and, in 1917, had an invested capital of $200,000, it would be entitled to deduct from its income 8 per cent of that amount, or $16,000. If the prewar rate was only 3 per cent, it would still be allowed 7 per cent, or $14,000. And, if the prewar rate was 12 per cent, it would be allowed 9 per cent, or $18,000. And these allowances are made after first deducting all expenses of conducting the business, including reasonable salaries to all who render service to the corporation and also after the

allowance of a specific exemption or deduction of $3,000.

An individual is allowed to make the same deductions, except that his specific exemption is $6,000, the larger amount being evidently intended to cover compensation for time given to the business.

The result is that, while the tax may seem heavy, one who pays it does nothing more than share with his Government in its hour of need, the excess of his income over and above a return of from 7 to 9 per cent of his capital plus a living wage for himself.

III.

The ordinary meaning of the expression "invested capital" is the amount of money which has been paid for property or into a business, and not the value of the property in which such money has been invested.

Since both the deduction and the tax are to be measured by the amount of *invested capital*, the case will turn upon the meaning of that expression. In general, and without reference to any particular definition given it by statute, it is not difficult to understand. The man in the street understands it perfectly. The amount of money or capital invested is one thing and the value of the property in which it is invested or of the investment is another and entirely distinct thing. And the difference is one of common everyday understanding.

If any owner of a piece of property purchased for $1,000 ten years ago should be asked to-day how much he has invested in that property, he would

unhesitatingly answer $1,000 plus any additional amounts which it may have cost him to hold it or which he may have expended in erecting improvements on it. It may be that no improvements have been erected, but that, as a result of changed conditions, the property is now worth $10,000. If he should be asked, therefore, what his investment of $1,000 is now worth, he would say $10,000. If he should be called on to make a financial statement for the purpose of obtaining credit, his prospective creditor would not be interested in knowing what had originally been invested in the property, but would be concerned only with its present and prospective future value. In such a statement, therefore, the property might properly be included as of the value of $10,000. This, however, would not be a representation as to the amount of capital invested in it. It would simply be a statement of the present value of his assets, regardless of how much he may have invested. If, after holding the property ten years, he should sell it for $10,000 and desired to know how much he had realized as profit on his investment of $1,000, he would deduct from the selling price the original purchase price plus any additional amounts expended on the property, and the remainder would be his profit. As long as he holds the property, however, the amount which it has cost him is the amount of capital he has invested in it, regardless of what its market value may be.

Again, it is a common practice of purchasers of stocks and bonds for income purposes to figure the

investment on the basis of what they pay. If a $1,000 bond bearing interest at 5 per cent is purchased for $800, the purchaser figures that he has better than a 6 per cent investment. This way of describing such transactions is in common use in business circles. It means that, regardless of what may be the ultimate value of the bond, the purchaser has invested $800 of his capital in such a way that it yields him an income of 6 per cent and better. If the market value increases, he may be able, by selling the bond, to realize an additional profit. If he does, this, like the annual interest received, will be a profit on his original investment of $800. If he does not sell, he will, at the maturity of the bond, for which he has paid $800, receive $1,000, and the additional $200 will be a further profit on the $800 invested. Under all circumstances, however, as long as he owns the bond, he has invested in it only $800 of capital.

If the act in question contained no definition of the term "invested capital," and that term should be given the meaning which it has in ordinary parlance, the result would be that, in the case of a corporation, it would include nothing except that which the corporation had received from its stockholders in exchange for shares of its stock and invested in the business. Certainly, it could not, if the words are to be taken in their usual and ordianry sense, be claimed that anything else is a part of its invested capital unless it be profits which it has earned and

retained in the business instead of distributing, or money paid in by stockholders, as is sometimes done, to be held and used as surplus.

Webster's New International Dictionary defines the verb "to invest" as:

> To make an investment; to lay out money; as, to *invest* in stocks—usually followed by *in*.

And Funk & Wagnall's New Standard Dictionary gives the definition as—

> To make an investment; as, to *invest* in bonds.

In other words, as generally understood, when an investment is made, capital is invested *in* something. The capital remains what it was at the time of the investment. The thing in which it is invested is not capital, but merely represents capital. Thus, the Century Dictionary defines "investment" as:

> An investing of money or capital; expenditure for profit or future benefit; a placing or conversion of capital in a way intended to secure income or profit from its employment; as, an investment in active business, or in stocks, land, or the like; to make safe investment of one's principal. THAT WHICH IS INVESTED; money or capital laid out for the purpose of producing profit or benefit.

The money thus laid out is what is invested or employed. This is what invested capital would ordinarily be understood to mean.

IV.

Except as modified, for the purpose of particular acts, the capital of a corporation has no other meaning in law than its ordinary meaning.

If necessary, it would be easy to demonstrate, from the decisions of this court, that, in law, the invested capital of a corporation has no meaning other than that which is ordinarily given it, and includes only the amount received by it for its shares of stock, is entirely distinct from the property in which invested, and does not include surplus and undivided profits.

In *Bailey* v. *Clark*, 21 Wall. 284, 286, there was a tax on capital employed in a business, and the court, speaking of the term "capital," said:

> When used with respect to the property of a corporation or association the term has a settled meaning; it applies only to the property or means contributed by the stockholders as the fund or basis for the business or enterprise for which the corporation or association was formed.

In the case of *Farrington* v. *Tennessee*, 95 U. S. 679, 686, construing a tax exemption provision in a bank charter, it was said:

> The capital stock is the money paid or authorized or required to be paid in as the basis of the business of the bank and the means of conducting its operations. It represents whatever it may be invested in. If a large surplus be accumulated and laid by, that does not become a part of it.

In *Tennessee* v. *Whitworth*, 117 U. S. 129, 137, speaking of a similar charter provision, it was said:

> These shares are to be subscribed and paid for, and the money raised in this way constitutes the "capital" of the corporation spoken of in section 12, where it is said, "the board of directors shall not exceed in their contracts the amount of the capital of the corporation," etc., and in section 17, where it is provided "that said company may at any time increase its capital to a sum sufficient to complete the said road."

In *Bank of Commerce* v. *Tennessee*, 161 U. S. 134, 147, it was said:

> The surplus belonging to this bank is "corporate property," and is distinct from the capital stock in the hands of the corporation. * * * The very name of surplus implies a difference. There is capital stock and there is a surplus over, above, and beyond the capital stock, which surplus is the property of the bank until it is divided among stockholders.

In *Powers* v. *Detroit & Grand Haven Railway*, 201 U. S. 543, it was held that a tax "on the capital stock of said company paid in" clearly referred to the property which the corporation had received and presumably still held.

Wright v. *Georgia Railroad & Banking Co.*, 216 U. S. 420, clearly recognizes the distinction between capital and the property in which it is invested.

It is not necessary, however, in this case to discuss the differences, if any, between capital, capital stock,

and corporate property, or to determine whether, in the absence of a statutory definition, surplus and undivided profits would be included in invested capital. The statute now under consideration defines for itself *invested capital* for the purposes of this tax, and, from a consideration of this definition, it must be determined whether the unearned increment of value which may have resulted from the purchase in 1904 of ore lands which appellant still owns is a part of its invested capital.

V.

As defined in the statute, invested capital includes but two items, (1) the amount originally invested in shares of its stock, and (2) surplus and undivided profits, and does not necessarily include all of either.

The definition of invested capital for the purposes of this tax is found in section 207 of the act. After excluding certain investments, it is enacted that, subject to this limitation, invested capital means:

> (*a*) In the case of a corporation or partnership: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid-

> in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year:
> * * *.

This definition is then qualified by a proviso to the effect that (*a*) patents and copyrights paid in for stock or shares shall be included, but only at their value at the time when paid in; (*b*) good will, trademarks, trade brands, the franchise of a corporation or partnership, or other intangible property shall not be included unless they shall have been actually purchased and payment bona fide made therefor specifically as such in cash or tangible property, and then only to the extent of the cash paid or the actual cash value of the tangible property paid therefor at the time of payment; and (*c*) such good will and other intangible property may be included if bona fide purchased prior to March 3, 1917, for and with shares of stock, but only at a value not to exceed the actual cash value at the time of purchase and in an amount not exceeding 20 per cent of the total shares of the capital stock of the corporation or the par value of the shares of stock with which purchased. It will be seen that this definition, taken as a whole, includes, first, the cash or tangible or intangible property which may be received by the corporation in exchange for its shares of stock, and, second, undivided surplus and profits. The amount paid in tangible property is fixed at the value of such property on January 1, 1914, a date shortly before our entry into the war, or, if paid after that date, at the

time received. Intangible property so paid in is to be included at its value when received. For the purpose, then, of ascertaining the amount of the original investment, there is no occasion to consider the value of the assets or corporate property in which the capital is invested, except to determine the value as of the dates stated of tangible or intangible property which has been paid in for shares of stock. With this exception, the only possible occasion, under the whole definition, of considering the value of assets is to determine what surplus or undivided profits existed prior to the taxable year and during the prewar period.

The definition, however, limits both the amount of the original investment and the surplus and undivided profits which may be included. Neither is to be included without limitations. Qualifying words are used to modify both. Certain property representing invested capital is not to be included. Only paid-in or earned surplus is to be included. The statutory definition must, therefore, be further examined to determine whether the unearned increment in this case is either capital or surplus or undivided profits within the meaning of the act.

VI.

As used in the act under consideration, invested capital does not necessarily include all the capital of the corporation, nor even all that it has actually invested, but only that which it has invested in assets the income from which is subject to the tax.

The definition of invested capital, so far as above quoted, is expressly stated to be subject to the limita-

tions contained in the first sentence of section 207. This is as follows:

> As used in this title "invested capital" does not include stocks, bonds (other than obligations of the United States), or other assets the income from which is not subject to the tax imposed by this title, nor money or other property borrowed, * * *.

Since this is made a limitation upon the definition which follows, it clearly means that any part, even of the original capital, which may be invested in property the income from which is not subject to this tax shall not be regarded as invested capital for the purpose of determining the amount of the tax or the deduction. If a part of the original capital is represented by such investments, it is not to be included, for purposes of the tax, in determining how much has been invested as original capital. If a part of the surplus and undivided profits has been so invested, it is likewise not to be included.

The reason for excluding stocks is clear. Dividends received on stocks are not income subject to the war excess-profits tax because the corporations paying them are themselves subject to that tax. Hence, these dividends do not constitute any part of the income upon which the recipient of them must pay this tax. In the case of bonds, they pay a fixed rate of interest, and ordinarily, if not always, a rate less than that which is exempt from war excess-profits taxes. It may safely be assumed, therefore, that interest collected on bonds will constitute no

part of the income subject to this tax. The reason for excluding stocks and bonds is also clearly indicated by enumerating them along with "other assets, the income from which is not subject to the tax imposed by this title."

The exclusion of money or other property borrowed was evidently inserted as a precaution to rebut any possible claim that borrowed money invested in the business of the corporation is invested capital.

The result is that capital invested in property of any kind, the income from which is not subject to the tax, is excluded with a single exception. The exception is in the case of obligations of the United States. These, of course, do not pay interest at a rate equal to the 7 per cent which is in all cases exempt from this tax. The reason, however, for permitting capital invested in obligations of the United States to be treated as invested capital is obvious. At the time this act was passed the Government, for the purposes of the war, was engaged in raising money both by levying taxes and selling bonds. It was as necessary to obtain a market for its Liberty bonds as it was to raise large sums by taxation. The owners of capital throughout the country were being urged to subscribe for bonds in large amounts. Such investments were being encouraged in every possible way. If the war excess-profits tax had been imposed in such a way that capital invested in Liberty bonds could not be treated as invested for the purposes of the deduction, the purchase of

the bonds would have been unduly burdensome. Indirectly, the small income which the investor would receive from them would become a part of the income on which he would be required to pay a heavy excess-profits tax.

The intention is clear, however, to exclude from invested capital, for the purposes of this tax, any capital invested in assets, other than obligations of the United States, which can not produce income which will be subject to this tax. This limitation, expressly imposed before Congress undertook to formulate its definition, itself excludes the unearned increment in this case from invested capital.

Mere increase in the market value of property is not a tangible thing separate and apart from the property itself. The ore lands in this case were used by the company in its business for the purpose of producing profits or income. They were capable of producing exactly the same income whether they were at the time capable of being sold only for the original purchase price of $190,000 or for $10,000,000. This increase in value did not, for the purpose for which the corporation was using them, increase by one cent the income derived from them. The increase in value, or the unearned increment, could not, therefore, under any circumstances, produce income which either would or would not be subject to the war excess-profits tax. The first sentence of section 207, therefore, clearly excludes it from invested capital.

VII.

The increment of value in this case can not be said to be included in that part of "invested capital" which consists of what has been received in exchange for shares of stock.

In a general sense the capital which a corporation employs in its business commonly consists of that which belongs to it and that which is borrowed. The first sentence of section 207, however, expressly excludes borrowed capital from invested capital, as used, with respect to this tax. As we have seen, this sentence also excludes any corporate assets, whether purchased with the original capital or other funds of the corporation, the income on which is not subject to the tax. It has been confidently insisted that this provision of the law alone makes it impossible to treat mere increase in the value of appellant's ore lands as invested capital. If, for any reason this contention is not sound, the same result is reached by a consideration of the definition which follows the sentence referred to. That definition must, of course, be applied to invested capital after excluding all borrowed capital and all assets the income from which is not subject to the tax, except obligations of the United States.

Invested capital thus limited is then defined in general to consist of two items: (1) That which the corporation has received in exchange for its stock, and (2) paid-in or earned surplus and undivided profits. The question then is whether the unearned

increment in this case is included under either of these headings.

That which the corporation has received in exchange for its share is divided into two classes—(1) cash and (2) property.

Property received in exchange for shares of stock is divided into three classes—(1) tangible property, (2) copyrights and patents, and (3) good will and other intangible property. The property so received by the corporation for the purposes of this tax is not treated exactly like cash received, the amount of which, of course, is definitely fixed at the time it is paid in. A difference is also recognized between such property when received for shares of stock and when merely purchased in the course of the business after the stock has been paid in. This difference is that, in the latter case, the property merely represents the capital invested in it, or is the thing in which capital is invested. In the former case, it is capital itself. It is received not as the representative of capital, but as capital. So long as the corporation holds it and uses it for the purposes of the business, it remains capital as distinguished from that in which capital is invested. Since the amount of this part of the capital is not fixed and definite, but depends upon the value of the property of which it consists, it may vary from time to time. Whatever its value may be at a given time constitutes a part of the capital of the corporation. It would, however, be impracticable and confusing if, for each taxable year, a new valuation had to be put upon it. It

was desirable and important that there should be some fixed and established rule by which the tax could be determined. Since invested capital is the basis for fixing both the rate of taxation and the amount of the deduction, the value of this part of the capital must be fixed both for the prewar period and for the taxable year.

With respect to tangible property received for shares of stock Congress has, therefore, selected January 1, 1914, the end of the prewar period as defined, as the date upon which the value of this part of the capital shall be fixed for both purposes. The result is that all tangible property which has been received in exchange for shares of stock is to be treated as invested capital to the extent of its value on that date, except that that received after January 1, 1914, is to be valued as of the date when received. With respect, however, to copyrights and patents and good will and other intangible property received for shares of stock, Congress apparently thought that their values were, at best, uncertain and indefinite, and therefore provided that they should in all cases be valued as of the date when received, whether before or after January 1, 1914; and, with respect to good will and other tangible properties, enacted that they shall not be recognized as invested capital to an extent in excess of 20 per cent of all the shares of stock of the corporation. And in no event shall these values exceed the par value of the shares issued in exchange for the property.

The result is that, as representing the original capital, or that which has been received in exchange for shares of stock, there shall be included (1) cash paid in, less such part thereof as is invested in assets, other than obligations of the United States, the income of which is not subject to the tax, and (2) tangible property so received prior to January 1, 1914, at its value as of that date, and tangible property received after that date, and patents and intangible property received at any time at their value at the time received, provided that the amount included for good will and other intangible assets shall not exceed 20 per cent of all the shares of stock.

Leaving out of consideration, for the present, the effect of a stock dividend in 1912, which will be referred to later, it is manifest that the increment of value in this case can not be included as a part of the original investment or what was paid in for shares of stock. It is not and has never been cash. Neither it nor the lands to which it is an incident were received by the company in exchange for its shares of stock. If it is anything tangible, it is merely something which has resulted from the purchase by the corporation of ore lands with a part of its capital, its earnings, or borrowed money. Obviously, it can not be brought within the definition of invested capital unless it can be said to be a part of the paid-in or earned surplus and undivided profits.

VIII.

Regulations promulgated by the Commissioner of Internal Revenue under which the tax in this case was computed.

Section 213 of the act in question provides:

> That the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall make all necessary regulations for carrying out the provisions of this title, * * *.

In accordance with this authority regulations were promulgated. The tax in question was collected in strict accord with these regulations. Hence, if the latter are valid and within the authority conferred, the tax was legally collected. So far as these regulations refer to the amount to be included in invested capital as having been received in exchange for shares of stock they are as follows:

Regulations 41, Art. 42, provides that—

> The term "invested capital" as used in the excess-profits tax law means the invested capital of the present owner. The basis, or starting point, in the computation of invested capital is found in the amount of cash and other property paid in, the original values of such other property being determined in accordance with the rules laid down in these regulations.

Article 55 is as follows:

> *Valuation of tangible property paid in for stock or shares.*—Tangible property *paid in for stock or shares* prior to January 1, 1914, must be

> valued at either (*a*) the actual cash value of such property on January 1, 1914, or (*b*) the par value of the stock or shares specifically issued therefor, whichever is lower. This is one of the few cases in which the law permits allowance to be made for appreciation, and *here no appreciation can be recognized unless the original stock or shares were specifically issued in exchange for such tangible property.*

If, then, the regulations according to which surplus and undivided profits have been computed are valid, there can be no question but that the tax was properly collected. These regulations are as follows:

Regulations 41, article 42, after stating the basis or starting point in the computation of invested capital, as quoted above, continues:

> But the computation does not stop with such original entries or amounts; it must take properly into account the surplus and undivided profits. In the computation of surplus and undivided profits, however, full recognition must first be given to expenses incurred and losses sustained from the original organization of the business concern down to the taxable year, including among such expenses and losses a reasonable allowance for depletion, depreciation, or obsolescence of property originally acquired for cash or for stock or shares or in any other manner. *If value appreciation of a kind not subject to income tax (other than that allowed under article 55) has been taken up in the accounts, a deduction must be made in respect of such appreciation so taken up.* In the computation of

the invested capital for any year full effect must also be given to any liquidation of the original capital.

Article 64 is:

> *Reconstruction of surplus and undivided profits accounts.*—Where through failure to provide for depletion, depreciation, obsolescence, or other expenses or losses, or where for any other cause or reason the books of account of the taxpayer do not show the *true paid-in or earned surplus* and undivided profits, in the computation of invested capital such adjustments shall be made as are necessary to arrive at a statement of the correct amount.

It will be seen that these regulations require a balance to be taken to ascertain how much in the way of surplus or profits the corporation has invested in its business in addition to the original capital. The books of the corporation are not to be taken as conclusive, but the account is to be so stated and adjusted as to arrive at the correct amount of actual profits. No mere appreciation in value which has not assumed a form in which it is subject to income tax in the hands of the corporation is to be included as a profit within the meaning of the act. To this end, if it is found that, under its system of bookkeeping, any such appreciation other than that allowed under article 55 in the case of property specifically paid for shares of stock, has entered into any of the accounts which must be considered in determining the surplus or profits, a deduction

to this extent must be made from what would otherwise be shown to be the surplus and profits.

In accordance with these regulations the increase in value of appellant's ore lands was not considered in determining the surplus and undivided profits which should be added to the original investment. In other words, such appreciation in value was not regarded as either paid in or earned surplus. If there is any error in the amount of tax collected, it arose from following these regulations as to surplus and undivided profits. If the regulations are valid and according to law, the appellant has paid only what it was bound under the law to pay.

IX.

The regulations as to surplus and undivided profits are in accord with the recognized principles of accounting as applied to business throughout the country.

Accounting is now a recognized science and has a literature of its own. It is a science according to which the business of the country is conducted, and, as a result, the terms "surplus" and "undivided profits" have come to have a fixed and definite meaning in the business world. In enacting this statute, Congress was speaking to the business world, and must be deemed to have used the words it employed in the sense in which they are understood in that world. The authorities on accounting are all agreed that, for the purpose of determining surplus and undivided profits, only realized profits are to be

considered and no account can be taken of mere appreciation in value. Where property used in a business is of such a character that wear and tear or depreciation of that kind results from its use, this depreciation must be taken into consideration. So, where the value of property is increased by additions to or improvements upon it, the amounts thus invested in betterments must also be taken into consideration. But mere changes in the price at which property might be sold is not a proper element of value to be considered in determining surplus or undivided profits. We quote from a few authorities on this subject.

> In business corporations it is customary to separate the capital stock and profits by calling the latter "surplus." (Esquecre on Applied Theory of Accounts, p. 30.)
>
> Surplus account should represent the accumulation of undivided profits. It may include items other than realized profits, or it may be diminished by writing down assets below their real value. When this is done the process is called "creating a secret reserve." When the credit side of the surplus account is increased by figures which do not *represent realized profits*, the act is called "creating fictitious assets," or "watering the assets." * * * When an asset account is arbitrarily increased by a book entry, the credit usually finds its way to surplus. When a business wishes to falsify the amount of its surplus it usually does so by inflating some fixed asset account. (Bennett, on Corporation Accounting, p. 94.)

In corporation accounting it is necessary to keep the accretions of wealth separate from the original capital contributions. Nevertheless there is customarily a closing of the books, and an apportionment of the annual profits of corporations. * * * At such a time a part of the profits are normally voted as dividends and immediately pass out of the control of the corporation. But it is unusual to distribute all of the profits earned and there is ordinarily further action by the directors or stockholders deciding to retain part of the profits. The profits thus reserved from distribution are called surplus and constitute an addition to the capital of the concern. * * *

Some technical exceptions are to be found to the statement that a surplus means reserved profits. A surplus occasionally is established by a corporation *de novo*, before any profits have accrued, out of part of the contributions, made directly by the stockholders. This is particularly the case in organizing banks where stock is often subscribed for at a premium. * * * Occasionally, too, stockholders make a voluntary contribution, generally of stock, for the purpose of providing means for raising cash for working expenses, which again creates a surplus not derived from profits. * * *

Surplus indicates a portion of profits withheld from distribution for the purpose of establishing a permanent addition to the effective capital of the concern. It does not imply any specific use to which it is to be put

and is perhaps the most comprehensive of all the terms employed to designate reserved profits. * * *

Undivided profits merely indicates, as the name suggests, a portion of the profits on which no specific action was taken. But the fact that it was not voted as a dividend does constitute it, in fact though not in name, a surplus reserve. The reason for differentiating is the unwillingness to distribute so closely the profits as to run the risk of having a debit balance appear in the profit and loss account. (Hatfield, on Modern Accounting, pp. 233–237.)

Changes in value of capital assets.—It is true that from the point of view of *earnings* such increment can not be taken as in any way a proper offset to losses due to wear and tear, depreciation or obsolescence; but this does not alter the fact that in spite of an insufficient provision for depreciation on some assets, there may be an actual increase on the total value of all assets. In fact, there are well-known cases in which by far the larger part of the ultimate profits of a corporation over a long series of years has been due not to the result of its activities but to the large unearned increment on its capital assets.

This condition must be recognized and is frequently met by means of careful appraisals of all properties, the resulting increase (or possibly decrease) being taken up as a special credit or debit to profit and loss account (or surplus) and shown as entirely distinct from the operating results. (Dickinson, on Accounting Practice and Procedure, p. 81.)

In this case it must be stated that where an asset has been purchased for the purpose of producing an income, and not for the purpose of a resale, it comes clearly under the head of "fixed assets" and no fluctuations can have any bearing on its book value. (Journal of Accountancy, Vol. III, p. 102.)

Fixed and floating assets.—The justification for thus ignoring fluctuations in the value of capital assets is that these assets have been acquired, and are being permanently retained, not with a view to their being eventually realized at a profit in the ordinary course of business, but with a view to their being *used* for the purpose of enabling trading profits to be made in other ways. For example there is no fixed connection between the realizable value of a ship and its earning capacity; and in the case of a factory, its value to the undertaking depends merely upon the accommodation that it offers, and is entirely irrespective of any speculative rise or fall that may have taken place in the value of the land or building materials. Similarly, the value of machinery to a business depends upon the amount of work that can be turned out, and not upon the market price of iron or steel at that particular time. For practical purposes, therefore, these fluctuations may fairly be said to be of no account, and in any event it is quite an open question whether, *pending a realization* (which is not contemplated), any more reliable basis of value could be adopted than the actual cost in the first instance. * * * It has already been stated that *under no cir-*

cumstances should appreciation in the value of fixed assets be credited to revenue. (Dicksee, on Advanced Accounting, pp. 5, 6.)

The general principle underlying the valuation of *fixed assets is that they shall be carried at cost regardless of current fluctuations in value,* but that accounting devices to measure lessening value must be taken into consideration. There is always some justification for arguments that favor a recognition of the market price *in the case of working assets,* but no sound arguments can be brought forward in justification of a similar treatment of fixed assets. * * *

Managers and owners often protest bitterly when told that they must make provision for depreciation of the fixed assets, but they are not allowed to offset this by an increased value of land. If a building is depreciating at the rate of $2,000 a year and land is appreciating at the rate of $3,000 a year, it seems reasonable to the owner or manager to consider that a $1,000 gain has been made.

There appears to be some justice in the claim that an unfair showing of profit and loss is made when current depreciation is required and current appreciation is ignored. The rule is, however, a very sound one. To a going concern, rapidly appreciating real estate has no more value than when it was first purchased, and on the principle of regarding assets from the viewpoint of the going business, real estate and similar assets must plainly be valued at cost. (Gilman on Principles of Accounting, pp. 179, 181.)

Prof. William Morse Cole, of Harvard University, discussing "Accounts, their construction and interpretation," says, at page 173:

> As a matter of fact, few accountants would recommend changing the value on the books. As we shall see later, the best accounting uses "cost" as a basis. An increase of value in a thing still held is not profit: profit can not arise until the thing is sold.

Of course, if an account is had not for the purpose of ascertaining just what profits have actually been realized, but how much a man or a business is actually worth at a given time, assets must be taken at their real value at that time. The purpose of such an accounting, however, is altogether different from that of an accounting in order to ascertain what profits a going concern has realized. The quotations from authorities on accounting which we have given above show that there is in the business world a generally recognized rule to the effect that, in determining the amount of surplus or undivided profits, no consideration is to be given to mere appreciation in value—at least of assets which are held for use in the business and not for resale. The reason for this rule is admirably stated in the concluding sentence of the paragraph quoted above from Prof. Cole, namely:

> An increase of value in a thing still held is not profit: profit can not arise until the thing is sold.

The authorities quoted above also show what Congress had in mind when it used the expression

"paid in surplus." That applies to the premium paid by original subscribers for stock for the purpose of creating a surplus, or to funds subsequently paid in by stockholders for the purpose of being held as a surplus. Of course, there is nothing of that kind in this case. If this increment of value is to be included at all, it must be upon the theory that it is *earned* surplus or profits. Nothing can be said to be earned by one until he has done all that must be done to entitle him to that thing. To earn a profit by buying and selling property of any kind, one must both buy and sell. No profit is made by merely buying. It is only common sense, then, to say, as Prof. Cole says, that a profit can not arise until the thing purchased has been sold. According to the sense, then, in which the words used in this statute are universally understood in the business world, the unearned increment which has progressed in the direction of a realized profit only to the extent that it is possible for the owner of property to sell it at a profit is not an *earned* profit.

Indeed, it may be said that the earned profits of a corporation for a given period are synonomous with its earnings or income for that period. It would follow that whatever has not become the income of the corporation in such a sense as to be a part of its taxable income would not ordinarily be understood to be earned profits for the purpose of this particular tax.

X.

Law text writers agree with the authorities on accounting as to the meaning of earned surplus and profits as used in this statute.

It can not be said that this particular section of the statute has yet been judicially construed. It has, however, been the subject of discussion by several eminent law writers, and there seems to be no difference of opinion among them. Thus, in Holmes, on Income Tax (1918 edition), at page 521, it is said:

> Earned surplus is that part of the surplus which has been accumulated by retaining in the business a part of the earnings of any year. The amount of such surplus is a question of fact to be determined in each particular case. The amount of earned surplus of any year since January 1, 1909, will probably be held to be the amount of net income, shown by the return of net income of the corporation, which has not been distributed in the form of dividends to the stockholders.

The same writer, in his 1919 edition on Federal Taxation says, at page 727:

> *Surplus and undivided profits.*—Paid in or earned surplus and undivided profits at the beginning of the taxable year may be included as invested capital. Surplus and undivided profits earned during the year may not be included. Appreciation in values due to reappraisement can not be regarded as paid in or earned surplus.

Earned surplus.—Only true earned surplus and undivided profits can be included in the computation of invested capital, and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the correct amount.

In Prentice-Hall Tax Service, for 1919, a service prepared by both lawyers and certified public accountants, it is said, at page 615:

Appreciation of tangible assets.—No appreciation in the value of tangible assets will be considered in the determining of invested capital. The original valuation of the assets having been determined in accordance with the rules above stated, the valuation may not be written up to represent an increased value. Thus, if a mine has been purchased in 1910 for $100,000, and in 1913 the value of the mine has become $500,000, the property must still be included in invested capital at its original cost. The fact that the property had value on March 1, 1913, which was substantially in excess of the cost may be sufficient ground for claiming the benefit of the relief clause which is explained later.

XI.

The capital and surplus of a corporation are held and used in exactly the same way. Neither is kept in cash. Both are invested in property for the purpose of producing income. The amount of each which can be said to be invested is the cost and not the value, at a particular time, of the property in which it is invested.

It has been seen that, so far as the original capital is concerned, the amount deemed to be invested is the amount paid in, without regard to the present value of the property in which it is invested. To this, however, may be added certain profits which, instead of distributing, the corporation has employed or invested in its business. The theory is that, to the extent that profits have been realized and invested for the purpose of earning further profits, there has, to all intents and purposes, been an additional investment of capital. The limitation contained in the first sentence of section 207 applies to all "invested capital"—to surplus equally with the original capital. Surplus invested in stocks, bonds, or other assets the income from which is not subject to the tax can not be taken into consideration as surplus which may be included in invested capital.

The capital originally invested remains the amount paid in no matter what the value of the property purchased by it may have become. The increase in value of such property is carefully excluded from this item of invested capital. But if, under the next item, this same increase may be treated as constituting invested surplus, Congress has had its pains for

nothing. If the capital originally paid in is to have added to it a surplus including increase in value of assets purchased with the original capital, the mention of cash paid in was entirely useless. It would have been much simpler to have, at once, said that invested capital shall consist of the value of all corporate assets. This not only was not said but, as will be shown later, Congress expressly rejected a proposition to that effect. The theory of the act is that the amount invested and not the subsequent value of corporate assets shall constitute invested capital. It applies, by the express terms of the act, to capital originally invested. It can not be so applied unless also applied to the additional investment of surplus. Certainly, Congress could not have intended to carefully exclude increase in value in one sentence and then to include it in the next for the purpose of creating a surplus.

Corporate assets must, of course, be taken into consideration in determining what the surplus is. But it is only a surplus which has been employed; that is, invested in the business that is to be ascertained for the purposes of this tax. It is to be ascertained by determining how much, in addition to the original capital, has been paid out for or invested in corporate assets. To the extent that this exceeds the liabilities, there is an earned surplus. In other words, in order to determine the surplus, corporate assets are to be taken at cost and not at present value. To include in surplus and undivided profits any element of value which is excluded from

original capital would be to reverse the whole theory of the law.

In this case the appellant has never received the increase in value of its ore lands in such form that it could be invested in anything. It merely remains an incident of the capital originally invested. The appellant has the same lands it bought, and these lands, including their increase in value, represent no investment except that originally made. It is impossible to say that any further investment, from surplus or any other source, has been made in them.

XII.

Earned surplus and undivided profits do not include the unearned increment arising from increase in value of property still owned.

In speaking of surplus and undivided profits, Congress having used the qualifying word "earned," that word must be given some significance. A moment's consideration of the nature of profits arising from the investment of money will make plain the meaning intended.

Ordinarily one who invests in property has in mind two kinds of profits—those which are to be derived from the use of the property and those which may finally be obtained by its sale at an advanced price; in other words, the current profits which the property earns and the deferred profits consisting of the unearned increment of value which, if he has purchased wisely and sells at the right time, may yield him an additional profit. This, however,

is a mere possible or potential profit until it is earned or realized by a sale. As long as he chooses to hold the property it can not be said to earn any profits except those which he derives from its use.

In this case, appellant invested $190,000 in ore lands. In 1912, these lands still represented an investment of $190,000, but their value had increased to $10,000,000. No more current revenue could be derived by taking ore from them than if their market value was still only $190,000. The increase was still an incident of the original investment. Appellant could not possibly invest it in anything without first selling the lands. There were two courses open. The company might have sold the lands and taken all its profit at once. Had this been done, the cash representing the increase in value would have been surplus or profits which would be capable of investment and might very well be called *earned* profits. The other course was to keep the lands and take the profits, not all at once, but as the ores should be removed. This, appellant decided to do. It needed such lands for the purposes of its business, and hence it preferred to retain them and cause them to earn such profits as could be derived from the removal and sale or use of the ores. Under this plan the value of the lands will, of course, gradually decrease. Hence, some part of the net revenue derived will be a return of capital, but the remainder will be profits earned upon the investment. As they are received, they may be invested for the purposes of the corporation. If so,

they will be surplus or undivided profits which may be included in invested capital. In this way, it will be possible finally to convert all of this increase into "invested capital." But, in the meantime, the part of the "profits" not taken out will still be in the ground and constituting merely a part of the value of the property in which the original capital has been invested. The company has not increased the amount of its investment by a single cent. The possible profits to be derived from removing the ores have not been and may never be received. Until they are received in some form, it is impossible to say that appellant has invested them or employed them in its business. As to these lands, it is still employing in its business only the capital, $190,000, originally invested in them.

XIII.

That it was the purpose of Congress to make the cost and not the subsequent value of property in which capital (whether original or surplus) is invested the measure of the amount of invested capital is obvious when the history of the act in its passage through the two Houses is considered.

During the proceedings in Congress which resulted in the imposition of this tax there was a difference of opinion as to whether it should be a mere excess profits tax—that is, a tax levied on the excess of net income over a fixed return—or a war profits tax—that is, a tax imposed upon such parts of the net income as could be said to have resulted and been brought about by war conditions. The act now

under consideration is, in the main, a mere excess profits tax, though in its computation some consideration is given to the theory of a war profits tax.

The first act on the subject was that of March 3, 1917 (39 Stat., c. 159, p. 1000). The tax then imposed was a pure excess profits tax. It was a tax of 8 per cent of the amount by which the net income exceeds the sum of (*a*) $5,000, and (*b*) 8 per cent of the actual capital invested. By section 202 of the act, invested capital was defined to mean: "(1) Actual cash paid in, (2) the actual cash value, at the time of payment, of assets other than cash paid in, and (3) paid in or earned surplus and undivided profits used or employed in the business; but does not include money or other property borrowed by the corporation or partnership." This definition, it will be seen, is, with certain modifications, carried into the present act.

The act of October 3, 1917, as it originally passed the House, was also a pure excess profits tax. Section 202 used the same language as that quoted above from the act of March 3, 1917, with the added proviso:

> That the good will, including trade-marks, trade brands, or the franchise of a corporation or partnership is not to be included in the actual capital invested unless the corporation or partnership, made payment therefor specifically as such in cash or tangible property, the value of such good will, trade-marks, trade brands, or franchise not to exceed the actual cash or actual value of the

tangible property paid therefor at the time of such payment.

There was opposition to the measure upon the ground that, in determining the amount of invested capital, the market value of the corporate assets should be considered rather than the amount of money which had been invested in them. In the discussion, however, there was no difference of opinion between advocates and opponents of the bill as to what the language employed meant. They were fully agreed that this language made invested capital the amount of money invested and not the value of the property in which it was invested. (55 Cong. Rec., pt. 3, pp. 2544 et seq.)

When the bill went to the Senate, the prevailing theory there was that the tax should be a war-profits tax rather than a mere excess-profits tax. The Senate committee, therefore, substituted for this tax, as it had been provided by the House, an entirely new tax. Instead of a flat rate on the excess, as provided in the act of March 3, 1917, and as continued in the House bill, a graded tax was imposed, the rate depending upon the amount of the excess. In the effort to reach strictly war profits, the committee took as the basis, or beginning point of the computation, the average profits which the corporation had earned during the three years preceding the war. In the discussion, however, it was found that to base the tax entirely upon this would result in many inequalities and in the loss by the Government of a large amount of taxes. The committee, how-

ever, retained the prewar profits as the basis for the amount of deduction which should be allowed, but provided that the deduction should not, in any case, be less than 6 per cent nor more than 10 per cent of the invested capital. The definition of invested capital, however, was by the committee but slightly changed from that in the House bill. (55 Cong. Rec., pt. 6, p. 6433; Id. pt. 7, p. 6453.)

In the discussion in the Senate there was still no difference of opinion as to the meaning of the definition of capital. It was understood by all to mean the amount of money invested and not the value of the property in which it was invested. Thus, Senator Simmons, the chairman of the committee, in explaining the action of the committee, said:

> We based it upon the capital invested in the business on the 1st day of January of the taxable year; but in the other part of the definition, which the Senator very carefully fails to read, we declare that in ascertaining the value of the amount of that capital, if there is any property in it that represents cash, such property shall be valued as at the time of the transaction. (55 Cong. Rec., pt. 7, p. 6455.)

There was opposition to this method of computing invested capital, and an amendment was proposed by Senator Bankhead to the effect that the invested capital should be based upon the actual value of all the corporate assets. (Cong. Rec., vol. 55, pt. 7, p. 6443.) Speaking of this proposition, Senator Simmons said:

> It is simply a flat proposition and values the property of the corporation for the purposes of

> ascertaining the capital at what it would sell for now—at the high prices which now obtain, with all of the unearned increment since it was actually acquired added. (55 Cong. Rec., pt. 7, p. 6453.)

The amendment was rejected.

Another amendment was offered which would have eliminated the question of invested capital and based the tax entirely upon income. (55 Cong. Rec., pt. 7, p. 6874.) This was also rejected. The discussion found in 55 Cong. Rec., pt. 7, p. 6486, shows that it was thoroughly understood that the language employed defined invested capital as the amount of money invested and not the value of the property in which it was invested.

When the act went to a conference committee, the differences between the House and Senate were settled by substituting an entirely new bill, so far as the excess-profits tax was concerned. These differences are fully explained in the report of the committee and the statements explaining them made by Senator Simmons in the Senate and Mr. Kitchin in the House. (55 Cong. Rec., pt. 7, pp. 7580, 7582; id., pt. 8, pp. 7615–7618.)

From this it appears that the general principle of the Senate bill as to a graded tax and giving some consideration to prewar profits was adopted. The allowance, however, on the latter account was fixed at not less than 7 per cent nor more than 9 per cent, instead of not less than 6 per cent nor more than 10 per cent. There were some slight differences as to

what should be included in invested capital, and changes from both the House and Senate bill were made in this regard. But there was no difference on the proposition that whatever was to be included in invested capital was to be included at its cost and not at its present value. This rule, which was the basis of the House bill from the beginning, entered into the recommendation made by every committee of both Houses and was involved in the act as it passed each House and was finally adopted. It would seem very clear, therefore, that Congress understood that the language which it employed had this effect.

XIV.

That Congress still so understood the definition of invested capital when it later passed the act of 1918 is shown by what then occurred.

The revenue act of 1918 (40 Stat., c. 18, Title III, pp. 1057, 1088) also included an excess-profits tax. With some minor changes, the definition of invested capital as contained in the act of 1917 was carried into this act. Apparently some question had been raised as to whether invested surplus included in invested capital should be computed upon the cost of the property. And in the proposed bill it was expressly provided that such surplus should not include "the increase in the value of any assets above the original costs until such increase is actually realized by sale." This language, however, was stricken out by the Senate committee and did not go into the bill as passed. This can not, however,

be taken to indicate that Congress did not even then consider the act of 1917 to mean what has been stated above. On the contrary, the language proposed was rejected because deemed unnecessary and because it might be construed so as to interfere with certain other provisions of the act intended to give relief in cases of unusual hardship or injustice. Senator Simmons, reporting for the committee the reason for rejecting this language, said:

> The committee refrains also from recommending any radical change in the method of computing invested capital, although a number of important improvements are suggested in this connection. Speaking generally, assets are valued, for the purpose of determining invested capital, at the price paid in acquiring them without recognition of subsequent appreciation. Weighty arguments have been presented in favor of abandoning this rule and valuing property acquired before March 1, 1913, as of that date. But the committee believes that such a method would be impractical; that it would impose upon the Treasury Department the impossible task of valuing nearly all of the durable property of the country as of a date nearly six years in the past. The present statutory rule works well in a large majority of cases. The remaining cases, in which it works injustice, can and should be cared for by adequate relief provisions which the committee has carefully formulated and recommends.
>
> The committee therefore indorses the general rule expressed by the House bill in paragraph

(3) of subdivision (*a*) of section 326, but believes that in certain exceptional cases inability to recognize appreciation furnishes just ground for relief, and in order that such relief may not be imperiled by overemphasis upon the general principle recommends that the explicit denial of the right to include any increase in the value of assets above original cost be stricken from section 326. (Sen. Rep. No. 617, 65th Cong., 3d Sess., Dec. 6, 1918.)

The relief provisions referred to are found in sections 327 and 328 of the act of 1918, and as to some of them, they were not contained in the act of 1917. They vested a discretion in the commissioner with respect to adjusting taxes where the application of the general rule will result in unusual hardship or injustice. They are in no way involved in this case and need not be further discussed.

It can scarcely be said that the rejection of the proposed language in 1918 can have any effect to change the plain meaning of the language in the act of 1917, now under consideration.

XV.

Mere increase in the value of lands still owned does not constitute income. "Profits" which have never been income can not be said to have been earned and invested so as to become new or additional capital.

In computing the invested capital of a corporation nothing can be added to its paid-in capital unless two things have occurred: (1) Profits must have

been earned; (2) these profits, after being earned, must be "used or employed" in the business. The value of the property in which the capital is invested may have advanced and, in a general sense, it may be said that there has been an increase of capital. But the statute does not authorize any addition to "invested capital" to represent a capital increase of this kind. That would be to measure "invested capital" by the value of corporate assets and not by the amount invested. Before there can be such an addition, profits must be first earned and then employed or used in the business.

If it can be said that the increase in value, or unearned increment, of a corporate asset is, in any possible sense, earned profit, how can it be said that this increment, which has no separate existence and can be used in no possible way to produce income, is used or employed in any way whatever? The company has exactly the same tangible and usable property which it had before and no more. And that property is no more serviceable or profitable in the actual conduct of the business than it was when its value was less. The act obviously excludes any value which is not represented by something which is capable of being used to produce income.

We need not, in this case, concern ourselves with theories and refinements as to the distinction between capital and income. All income becomes the capital of the recipient as soon as it is received. It is not every increase in the value of one's capital that is income. A mere increase in value is not some-

thing that can be used or that comes to the owner distinct from his property. It inheres in the property and, until severed, must remain, as distinguished from income, a mere capital interest. But whatever comes to one as the fruits of labor or capital and comes separate and distinct from his capital and in such form that he can use it is income. It is equally true that neither a corporation nor an individual can be said to be employing or using "profits" in his or its business unless such profits have assumed a form in which they can be used or invested in something that can be used. In other words, until "profits" have first become *income* they can not become *surplus* employed in the business so as to be included in "invested capital."

It will, of course, not be claimed that mere increase in the value of lands is income. If these lands had increased in value $100,000 during 1917, that amount would not have been added to appellant's taxable income. The reason is that, until segregated, this "profit" is not income but is merely an increase of capital. No more could this increase in value be included in "invested capital" for the next year for the very good reason that, not having been segregated from the original capital, it merely gives an increased value to that capital, and has not become income or assumed a form in which it can be used in the business or produce income.

XVI.

The cases cited in support of the proposition that the unearned increment is a capital interest do not conflict with but support the contention that the same increment is not earned surplus or undivided profits employed in the business.

The cases cited to the effect that whatever value attaches to mere increase in the value of property while still held by the owner is a capital interest rather than income are by no means in conflict with the Government's present contention. As shown above, under a fair interpretation of the language used by Congress, such unearned increment can not be said to be earned profits employed in the business until it shall have first become earned profits or income which is capable of being invested in property. To say, therefore, that such increment is not income is but to say that it has not yet assumed a form in which, as profits, it can be invested or employed in the business so as to come within the statutory definition of "invested capital." These cases, therefore, sustain rather than conflict with the Government's contention.

In *Lynch* v. *Turrish*, 247 U. S. 221, the question was whether money received by a stockholder as his share upon the dissolution of a corporation was income when it was simply his share of the value of the corporate assets as they existed on March 1, 1913, and included no profits earned by the corporation after that date. In construing the corporation tax law of 1909 it had been repeatedly held that when

property which had been bought before the passage of the act was sold the profit would not necessarily represent income accruing after that date, but that the value of the property at the date of the passage of the act should be treated as capital. It was, therefore, held that since, by the sale of the corporate assets, nothing was realized in excess of their value on March 1, 1913, the amount received by the stockholder was not taxable income. The point is that this was not a holding that the unearned increment, so long as it was merely an incident to the property which the corporation owned, could be treated as earned profits invested or employed by the corporation in its business. On the contrary, the holding was that when the profits were realized by a sale they included nothing which had been earned after March 1, 1913.

The case of *Eisner* v. *Macomber*, 252 U. S., 189, involved no question akin to the one now involved. It merely held that profits earned by a corporation and employed in its business were not to be treated as income of the stockholder merely because the corporation saw fit to give him two certificates to represent the same thing that was formerly represented by one certificate. This would follow whether the profits upon which the stock dividend was based were profits which had been realized and reinvested or which were merely represented by an unearned increment of value. If the question had been whether the company itself was taxable on these profits as income, it would have been important to inquire whether they

were profits which had, in fact, ripened into income. If they were cash which had been realized in the operations of the company and then invested in other property for the purpose of carrying on or extending the business, they would have been taxable income, because they would have been earned and realized profits. If, on the other hand, they represented merely an unearned increment of value, the corporation would not have included them in its return of income, because they would not constitute income. This is in accord with our proposition that, in order to be earned profits which have been employed in the business, they must first assume the form of income.

The same may be said of the other cases cited. We have no quarrel with them and a detailed discussion of them is entirely unnecessary.

XVII.

Since the increase in value of these lands was not surplus or undivided profits used or employed in the business, the declaration of a stock dividend based on it did not convert it into invested capital within the meaning of the statute.

If we are right thus far in the contention that this unearned increment had not become earned profits employed in the business within the meaning of the statute, it can scarcely be insisted that it was or could have been converted into such earned profits by the mere declaration of a stock dividend in 1912.

At the very bottom of this act is the rule that, in determining invested capital, the par value of stock

issued shall not be conclusive. If stock of the par value of $1,000 is issued in return for $500 of cash paid in, the act requires that the par value of the stock be entirely ignored, and that, looking beyond it, the invested capital shall be treated as the amount paid in. If property worth $500 is received in exchange for stock of the par value of $1,000, the same rule is applied. The only exception is that in that case, for the reasons explained above, the taxpayer is permitted to take the value of these assets on January 1, 1914, instead of the value at the time received by the company. But this right is limited. The value so taken can not, in any event, exceed the par value of the stock issued in payment for the property. The result is that no valuation in excess of the par value of the stock issued can ever be considered. But, within this limitation, the value as of January 1, 1914, will be taken. This is the single exception to the rule that mere appreciation in value may not be taken into consideration in determining invested capital.

Obviously, the issuing of stock based on unearned profits can not be taken as conclusive. As in the case of tangible property received for shares of stock we look through the stock issued and value the property received, so in the case of stock issued as a stock dividend, we look through the stock to determine whether it is based on earned or unearned profits. Whether, therefore, the values represented by the shares of stock in 1912 can be included in invested capital necessarily depends upon whether the sur-

plus and undivided profits on which they were based were earned surplus and profits which had been employed in the business. As we have seen, this was not the case, and hence these shares of stock, for the purpose of computing invested capital, stand on no higher basis than the unearned increment of value upon which they are based.

XVIII.

Basing the deduction on the cost of corporate assets does not involve an arbitrary or unconstitutional classification.

Perfect equality under tax laws is impossible and is not necessary to the validity of such laws. The Constitution recognizes this, and, as has frequently been held, the only uniformity required is a geographical uniformity.

In making classifications for the purposes of taxation, Congress has a wide discretion. True, it has been said that a classification may be so purely arbitrary and without reason as to render the law unconstitutional. But rarely, if ever, has a tax law of Congress been found to be so arbitrary as to justify invoking that rule.

It is said that this law results in inequalities. The inequality complained of and illustrated in various ways, is this: It is said that, if appellant had, in 1912, sold its business to another corporation for cash, at a price which included the $10,000,000 increase in value of the ore lands, the latter corporation, if, in 1917, it had done the same business and employed the same

assets which appellant did and employed, would have been allowed a larger deduction, and hence would have paid a smaller tax than appellant paid. But there can be no constitutional objection to this result unless it can be said that to base an excess-profits tax on the excess of income over a fixed return upon the money actually invested is wholly arbitrary and without reason.

It can scarcely be said that that is arbitrary and without reason which is in accord with the ordinary practices and modes of thought. We have seen that the ordinary investor reckons his profits upon the basis of the amount originally invested. A subscriber for stock in a corporation regards the dividends he receives as the returns upon the amount he has paid in. As long as he receives a fair return upon this amount he is content. If a surplus is accumulated, this adds to the value of his stock and his share of it can, when he concludes to sell, be converted into an additional profit on the amount originally invested. Congress might, therefore, without doing violence to ordinary practices, have excluded from invested capital everything except the amount originally invested. But it has permitted all profits realized and reinvested to be included in precisely the same manner as the amount originally paid in. Nothing is excluded except the unearned increment. This is abundantly justified because such an increment is not and can not be employed in the business and does not produce income. There can certainly be nothing

arbitrary in making the cash invested the amount on which returns are to be computed.

Two corporations may own ore lands which, in a given year, have the same market value and produce the same income. One, however, may have purchased 20 years ago for $1,000,000, while the other purchased 10 years ago for $2,000,000. So far as ore lands are concerned, the latter company will be treated as having double the amount of the former's invested capital and will pay a smaller excess profits tax. But is there any real injustice in this? One has laid out twice as much money as the other, and must receive twice as much income before it will have the same rate of profit. But, it is said, both have enjoyed the same income and have used assets of the same value to produce it. This may be true; but the tax is on income and is very properly based on what produces income. The increase results from $1,000,000 invested in one case and $2,000,000 in the other. The increment of increased value in the one case adds nothing to the income. It represents merely a possible profit which the company has seen fit not to realize and use to produce income. When the company sees fit to sell, the profit will be realized. If then reinvested, it will become "invested capital." Until then it is an accumulating increment on which no income tax is paid and which produces no income to be taxed. There is, therefore, no injustice in refusing to treat it as though it were a part of the invested capital which produces income subject to the war excess profits tax. After all, there could

scarcely be a fairer way to impose a tax of this kind than to grade it according to the cost of the instrumentalities used to produce the taxable income, as this statute does.

CONCLUSION.

It is respectfully submitted that there is no error in the judgment of the court below and it should be affirmed.

WILLIAM L. FRIERSON,
Solicitor General.

DECEMBER, 1920.

○

Supreme Court, U. S.
FILED
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CLERK.

Supreme Court of the United States.

OCTOBER TERM, 1920.

No. 453.

LA BELLE IRON WORKS,
Appellant,

vs.

THE UNITED STATES.

APPEAL FROM THE COURT OF CLAIMS.

BRIEF IN SUPPORT OF CONTENTION THAT THE INCREASE OR INCREMENT OF VALUE IN THE CORPORATION'S ORE LANDS, AS CAPITALIZED IN 1912, CONSTITUTED INVESTED CAPITAL FOR THE TAXABLE YEAR 1917.

WILLIAM D. GUTHRIE,
HENRY M. WARD,
HENRY F. PARMELEE,
LANGDON P. MARVIN,
As amici curiæ by leave of court.

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Supreme Court of the United States,

OCTOBER TERM, 1920,

No. 453.

LA BELLE IRON WORKS,
Appellant,

v.

THE UNITED STATES.

APPEAL FROM THE COURT OF CLAIMS.

BRIEF FILED AS AMICI CURIAE BY LEAVE OF COURT.

STATEMENT OF THE PRESENT CASE.

The above-entitled case comes before the court on appeal from a judgment entered in the Court of Claims sustaining a demurrer to the sufficiency of the petition (record, p. 14) and dismissing the petition. All facts pleaded in the petition are, therefore, admitted.

As the arguments already filed have dealt with questions more far-reaching than the mere interpretation or construction of sections 201-208 of the Revenue Act of Congress of October 3, 1917,* under which the excess profits tax was imposed, and contain a discussion of what constitutes capital as distinguished from income, application for leave to file a brief as *amici curiae* is now made by the undersigned, to the end that the court

*40 Stat. 300, 302, Title II., War Excess Profits Tax.

may be advised of other aspects of the problems before it, arising under the Sixteenth Article of Amendment and the acts of Congress imposing taxes upon incomes, which are to be presented in appeals now on its calendar, namely, the cases of *Merchants Loan & Trust Co.* v. *Smietanka*, No. 608, and *Eldorado Coal & Mining Co.* v. *Mager*, No. 609, which are set for hearing on January 3d, and *Goodrich* v. *Edwards*, No. 663, in which a motion is about to be made for its advancement. The point is also involved in the case of *Brewster* v. *Walsh*, decided December 16, 1920, by District Judge Thomas in the District of Connecticut, where he held that appreciation in value of an investment after March 1, 1913, did not represent income within the meaning of the Sixteenth Amendment. That case, as we understand, is to be brought here by the Government on writ of error. In both the *Goodrich* and *Brewster* cases the undersigned are of counsel. The questions as to what constitutes capital as distinguished from income, and as to the power to tax as income realized increase or increment in the value of a permanent capital investment by sale or otherwise are directly involved in each of such cases.

The appellant, La Belle Iron Works, is a corporation organized in 1875 under the laws of the State of West Virginia (record, p. 1), and prior to the year 1904, it had acquired certain ore lands on the so-called Mesabi range at a cost to it of $190,000 (p. 4). After the lands had been thus acquired by the corporation, extensive exploration and developmental works were carried on, and it was thereby proved that these lands contained large bodies of ore (*ibid.*). Between the date of purchase, which was prior to 1904, as aforesaid, and the

year 1912, these ore lands greatly increased in value, so that in that year they were of the *actual cash value* of not less than $10,105,400, and this continued to be their minimum actual cash value during the years 1912 to 1917, inclusive (p. 4). Although somewhat inartificially alleged, it appears from the allegations of the petition that prior to 1912 the capital stock issued and outstanding was of the par value of $9,915,400, consisting of one class or common stock, and represented probably the capital used in exploration and development in addition to the $190,000 original cost of the ore lands, although the record fails to show the details of the corporation's capital assets other than its ore lands. In 1912 the corporation increased the valuation of its said ore lands on its books from their cost by adding thereto the sum of $10,000,000 to represent their increase in "actual cash value"; said item of increased value was carried to surplus, and a stock dividend was declared in par value equal to the sum of $9,915,400, which represented and thereby capitalized the increase in value of the ore lands so carried to surplus (p. 5).

The corporation's capital stock was thereupon duly increased to $10,000,000 par value of preferred stock and $10,000,000 par value of common stock; the original issue of outstanding stock was surrendered and cancelled, and one share of new preferred stock and one share of new common stock were issued in the place and stead of each share of the original stock so outstanding (p. 5). This would represent a total of $19,830,800 of outstanding capital stock.

The record shows that thereafter such increase in actual cash value was treated by the corporation as a

part of its invested capital, and that as such it was included in its excess profits tax return for the year 1917 as part of its "invested capital" of $26,322,907.14 (pp. 4-5), which showed $6,492,107.14 in excess of outstanding capital stock. The corporation's return so made certified that its invested capital amounted to $26,322,907.14, and that its total net income for the year 1917 was $12,856,759.80 (p. 9), and thereupon an income and excess profits tax was assessed against it in the sum of $5,139,109.84, which was paid by it (p. 4).

The Commissioner of Internal Revenue, however, disallowed said item of $9,915,400 as part of the corporation's invested capital, which item represented the increase of actual cash value and capitalization in 1912, as aforesaid, and reduced the invested capital of the corporation from $26,322,907.14 to $16,407,507.14; and on that basis assessed against the corporation an additional tax of $1,081,184.61 (p. 5). This increased tax was thereupon paid under protest, and application duly made for a refund (pp. 5, 6, 7, 11). A petition was thereupon filed in the Court of Claims to secure a refund of this overpayment of taxes (p. 10).

The said reassessment so made was based upon a ruling of the Commissioner of Internal Revenue that only the actual cost of the ore land at the date of purchase *prior to 1904*, namely, $190,000, could be considered in computing the "invested capital" of the corporation within the intent and meaning of the act of Congress of 1917, notwithstanding the *conceded* facts above stated, namely, (1) that the actual cash value of such lands in and subsequent to 1912 and on January 1, 1914, was not less than $10,105,400 (p. 4); (2) that such value

was capitalized in 1912 through a stock dividend by means of the issue of shares of capital stock of a par value not exceeding the actual increase in cash value of the lands, and (3) that at all times subsequent to its capitalization the item was treated by the corporation as a part of its invested capital (p. 5).

In sustaining the demurrer of the United States and dismissing the petition of the corporation, the court below stated its conclusions as follows (p. 13):

> "(1) That the act in question (40 Stat. 306) undertakes to define 'invested capital' and the averments of the petition cannot be said to bring the plaintiff's case within the definition of section 207.
>
> "(2) That the increase in value of plaintiff's ore lands, which was first declared to be surplus, and afterwards treated as the basis of a stock dividend, did not thereby become earned surplus or [undivided] profits or invested capital within the meaning of the Act of 1917. The stock dividend added nothing to, and took nothing from the corporation's invested capital.
>
> "(3) That the inequalities, which can arise in the application of the statute to particular cases, cannot be corrected by judicial construction, where the enactment is otherwise valid.
>
> "(4) That where the act is ambiguous or uncertain, the construction of it by the administrative officers charged with its execution is entitled to great respect."

It is submitted that the ruling or construction of the Commissioner of Internal Revenue was clearly erroneous, and that such was not the intent and is not the meaning and effect of section 207. The Revenue Act of 1917 plainly intended to fix as a measure of the tax it imposed the average value of the capital actually invested during

the taxable year, and not the value of the capital invested at some antecedent period. The sole question of law presented by the petition was (*vide* petition, p. 6, par. X) whether the petitioner was entitled to include in its excess profits return for the year 1917, as part of its invested capital, the actual cash value of its ore lands, so capitalized in 1912, and represented by outstanding shares of capital stock duly issued in 1912 to a par amount not exceeding such actual cash value.

It is deemed proper to add that whilst the facts in the case at bar establish that the increment or increase in value of the corporation's ore lands was capitalized in 1912 by the issue of $9,915,400 par value of shares of capital stock, and this aspect is sufficient to dispose of the point now presented for decision, it is nevertheless contended by the undersigned that even if such increase or increment in "actual cash value" had not been carried to surplus account and then transferred to capital by means of the stock dividend, it would, nevertheless, have constituted part of "the invested capital for the taxable year" within the true intent and meaning of sections 201 and 203 of the Revenue Act of 1917. The statute clearly contemplated that the value of tangible property actually used or employed in a corporation's business to earn profits, should be deemed invested capital, and the mere matter of bookkeeping entries would not be at all controlling. The facts according to substance and not mere form must determine what is or is not "invested capital for the taxable year . . . used or employed in the business," which has earned the gains and profits to be taxed.

I.

THE INCREASE IN VALUE OF THE ORE LANDS OF LA BELLE IRON WORKS WAS DULY CAPITALIZED IN 1912, AND THEREAFTER REPRESENTED PART OF THE INVESTED CAPITAL OF THE CORPORATION WITHIN THE MEANING OF THE EXCESS PROFITS TAX PROVISIONS OF THE REVENUE ACT OF OCTOBER 3, 1917.

It is a well-established rule in the law of corporations that actual growth or increase of value in the property of a corporation may properly be capitalized by the issue of shares of capital stock through a stock dividend, and that thereupon the shares so issued are to be treated as paid up as fully to all intents and purposes as if the increase of value had been realized by conversion and sale and the proceeds applied to pay for the stock.

Thus, in Cook on Corporations (7th ed.) vol. II, sec. 536, p. 1566, the author states the accepted rule as follows:

> "A stock dividend, as the name imports, is a dividend of the stock of the corporation. Such a dividend is lawful when an amount of money or property equivalent in value to the full par value of the stock distributed as a dividend has been accumulated and is permanently added to the capital stock of the corporation. Corporations frequently make a dividend of this character when improvements of the corporate property or extensions of the business have been made out of the profits earned. It is also made when the corporate plant has increased in value, and it seems better to issue new stock to represent the excess of value than to sell the increase and declare a cash dividend. In this country these dividends are frequently made, and are sustained by the courts." (Citing many authorities.)

In the most recent case upon the subject of stock dividends, *Eisner* v. *Macomber*, 252 U. S. 189, Mr. Justice Pitney, speaking for the court, among other things, said (at p. 211):

> "A 'stock dividend' shows that the company's accumulated profits have been *capitalized*.* instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to *capital*, and no longer is available for actual distribution."

The cases of *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179; *Hays* v. *Gauley Mountain Coal Co.*, *ib.* 189, and *Southern Pacific Co.* v. *Lowe*, *ib.* 330, conclusively establish that increase of value in and prior to 1912, that is, prior to the Sixteenth Amendment and to the passage of the taxing statute now before the court constitutes principal and not income. Thus, in the *Doyle* case (at p. 187), the court used the following language:

> "In our opinion these regulations correctly interpret the act in its application to the facts of the present case. When the act took effect, plaintiff's timber lands, with whatever value they then possessed, were a part of its capital assets, and subsequent change of form by conversion into money did not change the essence. Their increased value since purchase, as that value stood on December 31, 1908, was not in any proper sense the result of the operation and management of the business or property of the corporation while the act was in force. Nor is the result altered by the mere fact that the increment of value had not been entered upon plaintiff's books of account. Such books are no more than evidential, being neither

*Italics are not in opinions unless so indicated.

> indispensable nor conclusive. The decision must rest upon the actual facts, which in the present case are not in dispute."

In the *Southern Pacific Co.* case (at p. 335) the court again said:

> "We are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, as being capital, not income for the purposes of the act. *And we perceive no adequate ground for a distinction, in this regard, between an accumulation of surplus earnings, and the increment due to an appreciation in value of the assets of the taxpayer.*"

See also *Lynch* v. *Turrish*, 247 U. S. 221; *Alpha Portland Cement Co.* v. *United States*, 261 Fed. 339; *Miller* v. *Gearin*, 258 Fed. 225; *Palmer* v. *Pullman Co.*, 252 Fed. 286; *United States* v. *Guggenheim Exploration Co.*, 238 Fed. 231; *Baldwin Locomotive Works* v. *McCoach*, 221 Fed. 59; *Kenton Furnace Railroad & Mfg. Co.* v. *McAlpin*, 5 Fed. 737.

The case of *Bailey* v. *Railroad Company*, 22 Wall. 604, called for a construction by the court of section 22 of the Internal Revenue Act of June 30, 1864 (13 Stat. 284 as amended by the act of July 13, 1866; 14 *id.* 138), which provided as follows:

> "That any railroad company that may have declared any dividend in scrip or money, due or payable to its stockholders, as part of the earnings, profits, income, or gains of such company carried to the account of any fund or used for construction, shall be subject to and pay a tax of 5 per centum on the amount of all such dividends or profits, whenever and wherever the same shall be payable; and said companies are hereby authorized to deduct and withhold from all payments on account of any dividends, due and payable, as aforesaid, the tax of 5 per centum."

In the opinion of the court delivered by Mr. Justice Clifford it became necessary to analyze the nature and effect of a stock dividend in order to apply the analogy to the interpretation of the term "any dividend in scrip" as used in the statute. The tax then imposed would seem in its essence to have been an excise tax as distinguished from an income tax. *Flint* v. *Stone Tracy Co.*, 220 U. S. 108, 145, 150. Indeed, it was conceded by counsel in the *Bailey* case that stock dividends were "a proper object of taxation under the Internal Revenue Act" (see p. 635). The opinion pointed out that if this were so, "it is difficult to see why those certificates [*i. e.*, the scrip dividends there in question] are not, as they differ from the former only in the fact that they do not confer the right to vote and that they may be cancelled by payment out of the future earnings of the company". The opinion then proceeds to analyze the particular transaction before the court, and declares (at p. 637):

> "As a general rule stock dividends, even when they represent net earnings, become at once a part of the capital of the company, and, of course, entitle the holder to vote unless it is otherwise provided in the charter or by-laws."

And *a fortiori* must this be so when a stock dividend represents the growth or increment in *actual cash value* of capital assets, such growth in actual cash value resulting from exploration and development carried on for many years, an inference which the present record fully justifies (*vide* p. 5).

The general rule thus mentioned by Mr. Justice Clifford in the *Bailey* case was reiterated by Mr. Justice Gray in speaking for the court in *Gibbons* v. *Mahon*, 136 U. S. 549, 559, as follows:

> "Therefore, when a distribution of earnings is made by a corporation among its stockholders, the question whether such distribution is an apportionment of additional stock *representing capital,* or a division of profits and income, depends upon the substance and intent of the action of the corporation, as manifested by its vote or resolution; *and ordinarily a dividend declared in stock is to be deemed capital,* and a dividend in money is to be deemed income, of each share."

After analyzing the *Bailey* case, Mr. Justice Gray in his opinion proceeds to review the decisions of the courts of Great Britain with the scholarly exhaustiveness, discrimination and accuracy for which the learned Justice was pre-eminently noted. He introduced such review with the following statement (at p. 561):

> "In Great Britain, it is well settled that where a corporation, whether authorized or unauthorized by law to increase its capital stock, accumulates and invests part of its earnings, and afterwards apportions them among its shareholders as capital, the amount so apportioned must be deemed an accretion to the capital of each share, the income of which only is payable to a tenant for life."

And the concluding paragraph of the opinion contains the following statement which is entirely applicable to the case of La Belle Iron Works now before the court (at p. 569):

> "The resolution [in the case at bar the stock dividend in 1912 representing *actual cash value*] is clearly an apportionment of the new shares as representing capital, and not a distribution or division of income."

Likewise, covering the state of facts presented in the case at bar, is the language of Mr. Justice Pitney in *Doyle* v. *Mitchell Brothers Co.,* 247 U. S. 179, 187:

> "When the act took effect, plaintiff's timber lands, with whatever value they then possessed, were a part of its capital assets, and subsequent change of form by conversion into money did not change the essence. Their increased value since purchase, as that value stood on December 31, 1908, was not in any proper sense the result of the operation and management of the business or property of the corporation while the act was in force."

And the same may be said in substance of the case of *Gulf Oil Co.* v. *Lewellyn*, 248 U. S. 71, where Mr. Justice Holmes in his opinion emphasizes the fact that the earnings then in question "had been used as capital before the taxing year" and "practically had been converted into capital." In the case at bar, it is incontrovertible that the "actual cash value" in 1912 was then capitalized by means of a stock dividend "and at all times thereafter said sum [of $9,915,400] was treated by the petitioner as a part of its invested capital" (pp. 4-5), and this is admitted by the demurrer.

The cases of *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179; *Hays* v. *Gauley M't. Coal Co.*, *ib.* 189, and *United States* v. *Cleveland etc. Ry. Co.*, *ib.* 195, arose under the Corporation Excise Tax Act of August 5, 1909, c. 6, 36 Stat. 11, 112, sec. 38, which was *not* an income tax law at all. *Anderson* v. *Forty-Two Broadway Co.*, 239 U. S. 69, 72, and cases there cited. The case of *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, however, arose under the Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, and Mr. Justice Pitney stated (at p. 335), to repeat, that under this Income Tax Act "we are bound to consider accumulations that accrued to a corporation prior to January 1, 1913, as being capital, not income, for the purposes

of the act. And we perceive no adequate ground for a distinction, in this regard, between an accumulation of surplus earnings, and the increment due to an appreciation in value of the assets of the taxpayer." The case turned "upon its very peculiar facts", and is not an authority for the proposition that an increase or increment in the value of a capital investment would constitute income of a corporation or of an individual or trustee and as such taxable under the Sixteenth Amendment. No such question was before the court for decision.

Nor is there anything in the opinion of Mr. Justice Holmes in *Towne* v. *Eisner*, 245 U. S. 418, 426, to support a suggestion that the result in that case would have been different if the surplus transferred to the capital account of the corporation had been earned after January 1, 1913. On the contrary the reasoning of the court and the principle declared clearly cover a case where there had been a stock dividend to represent and capitalize surplus earned at any time. The same is true of *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71, 72. The reference in *Towne* v. *Eisner* to the fact that the surplus was earned before January 1, 1913, was evidently for the purpose of stating the exact group of facts before the court, and indeed in *Eisner* v. *Macomber*, 252 U. S. 189, 202, Mr. Justice Pitney said of the *Towne* case that the court had "disposed of it upon consideration of the essential nature of a stock dividend, *disregarding the fact that the one in question was based upon surplus earnings that accrued before the Sixteenth Amendment took effect.*"

The property capitalized in 1912 in the case of La Belle Iron Works had thereafter to be treated by the corporation as part of its invested capital, and as such part of a trust fund for the protection of its creditors; in other words, it could not any longer be treated as part of surplus or utilized to declare and pay dividends, for its character as surplus had been permanently changed by the transmutation into capital stock invested in the business. As the court said in the *Bailey* case (22 Wall. at p. 638):

> "Funds set apart as capital out of which debts are to be paid, it is held, amount to a contract with those who became creditors on the faith of the transaction that the fund shall not be withdrawn and appropriated to the use of the owner or owners of the capital stock."

When, therefore, in 1912, La Belle Iron Works issued capital stock equal to and representing "the actual cash value of the said ore lands", it was bound thereafter to treat said ore lands and any proceeds of a sale thereof "as a part of its invested capital"; and, as matter of fact, it was so treated by the corporation at all times in and after 1912 (p. 5), as the demurrer conclusively admits.

It would certainly be an anomalous result that what was plainly part of the capital of a corporation as to the state, the public, its creditors and its stockholders, for which an equivalent in par value of capital stock had been duly issued directly in payment or indirectly by way of a stock dividend (since as between the corporation and its stockholders this latter clearly constituted payment), and what the corporation was bound to treat as capital invested in its business was, nevertheless, not capital so invested under the acts of Congress imposing

income and excess profits taxes. Certainly the corporation could not thereafter treat the ore lands representing $9,915,400 of its capital stock other than as capital invested; and if it were upon any theory or notion whatever compelled to treat it otherwise, it could not declare any dividends until a sufficient equivalent for such excluded capital assets was made up and duly capitalized.

Thus, in the case at bar, the balance sheet of La Belle Iron Works, under the re-assessment of the Commissioner of Internal Revenue, would for the purposes of federal income taxation be at direct variance with the truth and the actual state of its accounts, and instead of having capital invested equal to its capital stock issued and outstanding (viz., $19,830,800), it would have to show a capital deficit of $3,323,303, being the difference between $19,830,800 and the $16,407,507 fixed by the Commissioner! This result would obviously preclude the payment of any dividends until the deficit was made up, and require a report and balance sheet showing an impairment of capital!

It should, it is therefore submitted, require very clear language to indicate that the term "invested capital" as used in the act of Congress in question meant something so entirely different from its current and common meaning under all other circumstances as would be necessary to support the ruling of the Commissioner in the particular case at bar.

II.

THE INCREASED ACTUAL CASH VALUE OF THE ORE LANDS SO CAPITALIZED IN 1912 CONSTITUTED PART "OF THE INVESTED CAPITAL FOR THE TAXABLE YEAR" 1917, WITHIN THE MEANING OF THE REVENUE LAW.

The term "invested capital" is repeatedly employed in the Revenue Act of Congress of October 3, 1917, and there is nothing in the context to suggest that any different meaning was in mind or any different effect contemplated than would be the ordinary meaning and effect of the term as understood in current and common usage. The pertinent sections of the statute may be briefly summarized.

The term "invested capital" of a corporation is first used in section 201 in fixing the rates of taxation on net incomes of corporations, which are graduated by percentages *"of the invested capital for the taxable year"*, and deductions are allowed based in part upon "the invested capital for the pre-war period." The amount of the "invested capital for the taxable year" is made the standard by which is to be fixed or measured (1) the amount of the deduction allowable, which is not to be subject to the excess profits tax, and (2) the graduated rate at which the surplus profits are to be taxed.

The statute then proceeds in section 207 to define and limit the term "invested capital" of a corporation so that it shall consist of one or more of the following elements: "(1) actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, 1914, the actual cash

value of such property as of January first, 1914, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year."

It must be manifest that the case of La Belle Iron Works specifically comes within subdivision 2 of section 207, for it is conceded on the record that the amount of capital in controversy, namely, $9,915,400, represented "actual cash value" on January 1st, 1914, and that an equivalent amount in the par value of stock or shares had been "specifically issued therefor". But if such increased cash value had not been capitalized in 1912, or if, *arguendo*, the stock dividend and subsequent increase of stock, surrender and exchange were treated as nullities, then in either view the "actual cash value" in excess of original cost had been properly "carried to surplus" (p. 5), and would, therefore, come within subdivision 3 of section 207, because plainly "earned surplus and undivided profits used or employed in the business" from 1912 onward.

If the ore lands had at the time of the original organization of the corporation been of the value of ten million dollars, and stock of like par amount had then been issued therefor, the stock so issued would, of course, now indisputably represent part of the invested capital under section 207, unless there had been a depreciation. In that case, "tangible property," that is, the ore lands, of an actual cash value of ten million dollars on January first, 1914, paid for in stock, would have come within the letter of the statutory definition in subdivision 2 of section 207.

If, again, the ore lands had been sold in 1912 for their "actual cash value" and other similar lands bought with the proceeds, the case at bar would equally be brought literally within the letter of the statute, and the full amount would be "capital invested." The mere difference in form cannot change the substance or nature of the transaction which took place in 1912. This transaction in effect capitalized what might have been otherwise readily realized upon, for we are dealing with what is *conceded* to be "actual cash value" and not mere estimates or expert valuations, and what thereafter constituted capital invested, "used and employed in the business" of the corporation, and treated as such, and what could not be drawn from such investment without duly safeguarding the rights of creditors and stockholders.

The mere form of the transaction by which the "actual cash value" of the ore lands was capitalized in 1912, cannot, of course, change its substance and effect. In order to capitalize such actual cash value, it was not necessary to adopt the circumlocution of selling the ore lands for cash and then reinvesting the proceeds in other similar lands. In such latter case, it is not to be supposed that any one would seriously contend that the proceeds so reinvested were not part of the *invested capital* of the corporation. Yet, the substance of the result would have been to all intents and purposes exactly the same. According to truth and substance, therefore, without regard to mere form, the actual cash value which had been carried to surplus and could have been realized upon, and the proceeds distributed in cash dividends among the stockholders, was carried to the capital account of the corporation; and it was as such permanently devoted to

and invested in the business of the corporation as fully as if the new stock issued therefor had been issued for cash and a cash dividend declared of an equal amount. The cash dividend would then have reimbursed the stockholders for the new capital contributed, but the actual capital invested in the business would have been exactly the same.

Hence, it follows that La Belle Iron Works was entitled to be allowed the "actual cash value" of its ore lands so capitalized in 1912 as part "of the invested capital for the year" 1917 as provided in section 201 of the Revenue Act of October 3, 1917.

III.

INCREASE OR INCREMENT IN VALUE OF A PERMANENT INVESTMENT CONSTITUTES CAPITAL AND NOT INCOME.

The brief to be filed in No. 663, to which reference is prayed, will discuss at length the question as to the true nature of any increase or increment in value of a permanent investment, and will urge that it is essentially capital and not income, within the intent and meaning of the Sixteenth Amendment to the Constitution of the United States. As the point is sufficiently discussed above so far as the case at bar is concerned, the more general argument applicable to other cases needs not, it is assumed, be repeated or elaborated in this brief.

CONCLUSION.

The ruling of the Commissioner of Internal Revenue in the case at bar was clearly erroneous, and the "actual cash value" of the ore lands as capitalized in 1912

constituted "invested capital for the taxable year" 1917 within the intent and meaning of section 201 of the act of Congress of October 3, 1917. The judgment of the Court of Claims should, therefore, be reversed.

Washington, D. C., January 3, 1921.

WILLIAM D. GUTHRIE,
HENRY M. WARD,
HENRY F. PARMELEE,
LANGDON P. MARVIN,
As *amici curiae* by leave of court.

LaBELLE IRON WORKS *v.* UNITED STATES.

APPEAL FROM THE COURT OF CLAIMS.

No. 453. Argued January 6, 7, 1921.—Decided May 16, 1921.

1. The Act of October 3, 1917, c. 63, Tit. II, 40 Stat. 300, 302, in providing for a deduction of a percentage of "invested capital" before computation of the "excess profits" tax upon the income of a domestic corporation, does not mean to include in its definition of invested capital (§ 207) any marking up of the valuation of assets upon the corporate books to correspond with increase of market value or any paper transaction by which new shares are issued in exchange for old ones in the same corporation but which is not in substance and effect a new acquisition of capital property by it. Pp. 386, 389.
2. A corporation, having acquired ore lands for $190,000, proved, by extensive explorations and developments, that their actual cash value was over $10,105,400; thereupon, in 1912, it increased their book valuation by adding $10,000,000, as surplus, and, based thereon, declared a stock dividend for $9,915,400, which was carried out by surrender and cancellation of all the common stock, of like aggregate par value, and the issuance of one share each of preferred and new common stock for each share of the stock surrendered. The increased value of the ore lands persisted when an excess profits tax was laid under the Act of 1917, *supra*. *Held:* That such increase of value was not included in "invested capital" under § 207 (a) (3), as "paid in or earned surplus and undivided profits," (though an amount equal to the cost of the exploration and development might be), pp. 386, 390; nor under *id.* (2) as "the actual cash value of tangible property paid in other than cash, for the stock or shares" of the corporation. Pp. 386, 390.
3. The Fifth Amendment having no "equal protection" clause, the

only rule of uniformity prescribed by the Constitution respecting duties, imposts and excises is the territorial uniformity required by Art. I, § 8. P. 391.

4. There were reasons, both theoretical and practical, including that of convenience in administration, for basing "invested capital" upon actual costs to the exclusion of higher estimated values; and resulting inequalities to corporations differently situated do not make out an arbitrary discrimination, amounting to confiscation and violating the due process clause of the Fifth Amendment. P. 392.

55 Ct. Clms. 462, affirmed.

APPEAL from a judgment of the Court of Claims disallowing a claim for a refund of money alleged to have been unlawfully exacted as an excess profits tax. The facts are stated in the opinion, *post*, 383.

Mr. Charles McCamic and *Mr. Charles E. Hughes*, with whom *Mr. Edward B. Burling* and *Mr. Jas. Morgan Clarke* were on the briefs, for appellant:

By the correct construction of the act the appellant is entitled to include as paid in or earned surplus and undivided profits, under § 207 (a) (3) of the act, the increase in the value of the ore lands due to the discovery of the ore bodies and to the natural increase in the market price of ore. The act contains no definition of the words "paid in or earned surplus and undivided profits."

Statutes imposing taxes are to be construed in favor of the taxpayer; the language employed is to be given its ordinary meaning; they are to be construed according to the spirit rather than the letter when the letter would make them palpably unjust; construed according to these rules the invested capital of appellant should include all its outstanding stock where that is represented by property of an actual cash value not less than the par value of the outstanding stock.

The ordinary meaning of the words "paid in or earned surplus and undivided profits," includes appreciation in

value. R. J. Bennett, Corporation Accounting, 1917, § 291, pp. 334, 336; Arthur Lowes Dickinson, Accounting Practice and Procedure, 1917, p. 62; Henry Rand Hatfield, Modern Accounting, 1916, p. 237; Harry C. Bentley, The Science of Accounts, 1913, § 36, p. 24; Leo Greendlinger, Financial and Business Statements (Alexander Hamilton Institute, 1917), vol. 22, pp. 195, 196; Year Book, 1911, p. 124.

Text writers on law and decided cases give the same definition of surplus and undivided profits as the accountants. Machen, Modern Law of Corporations, vol. II, pp. 1092, 1095; Morawetz, Private Corporations, 2d ed., vol. I, p. 412; Thompson, Corporations, 2d ed., § 5307; Cook, Corporations, 7th ed., vol. II, § 536; *Park* v. *Grant Locomotive Works*, 40 N. J. Eq. 114, 121.

The Department's definition, excluding appreciation from surplus, when analyzed closely, shows itself to be unsound; for it is admitted that when the property is sold the profit may become a part of surplus. But the sale does not create the profit. *Williams* v. *Western Union Telegraph Co.*, 93 N. Y. 162, 186, 191; *People* v. *Board of Commissioners*, 76 N. Y. 64, 74; *People* v. *Barker*, 165 N. Y. 305; *McGinnis* v. *O'Connor*, 72 Atl. Rep. 614; *Mangham* v. *State*, 11 Ga. App. 440; *Hutchinson* v. *Curtiss*, 92 N. Y. S. 70, 74; *Simcoke* v. *Sayre*, 148 Iowa, 132; *Anderson* v. *Farmers' Loan & Trust Co.*, 241 Fed. Rep. 322, 326; *Roberts* v. *Roberts-Wicks Co.*, 184 N. Y. 257; *Hubbard* v. *Weare*, 79 Iowa, 678; *Miller* v. *Bradish*, 69 Iowa, 278; *Equitable Life Assurance Society* v. *Union Pacific R. R. Co.*, 212 N. Y. 360.

The word "earned" does not limit the surplus which is to be included in invested capital. The statute merely contrasts "earned" with "paid in" surplus. The phrase in the act is "paid in or earned surplus and undivided profits." The meaning of "earned" is not the same as "realized." It includes in meaning "to acquire the

benefit of although not realized." *Stevens* v. *United States Steel Corporation*, 68 N. J. Eq. 373, 380; *Lewis's Estate*, 156 Pa. St. 337; *Nuding* v. *Urich*, 169 Pa. St. 289.

Our contention on this subject is that if the appreciation is surplus at all it is necessarily "paid in or earned" surplus. The word "earned" was probably used in contrast to "paid in" in the clause "paid in or earned surplus and undivided profits," and was perhaps intended to emphasize the thought that the surplus must be real and not fictitious.

If it be admitted that appreciation after realization is earned surplus, then it must be admitted that appreciation is earned surplus before the property is sold. The sale does not create the earning; it is the gradual increase in value which is the earning.

But if the word "earned" has any such narrow meaning as is contended for, that narrow meaning is not applicable to appellant in view of the facts admitted by the demurrer. The petition alleges that after the acquisition of the ore properties, extensive exploration and development work was carried on, and that by 1912, and at all times thereafter to 1917, the actual cash value of the ore lands was not less than $10,105,400.

New capital stock of the company was issued because the value of the ores justified it and this was a realization of the increased values.

This court in construing the 1909 corporation excise tax law, and the 1913 income tax law, held that appreciation accruing before the incidence of the tax was capital. The word "capital" as used in these cases must include "surplus." *Hays* v. *Gauley Mountain Coal Co.*, 247 U. S. 189; *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 187; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 335; *Towne* v. *Eisner*, 245 U. S. 418; *Lynch* v. *Turrish*, 247 U. S. 221; *Lynch* v. *Hornby*, 247 U. S. 339.

The construction here contended for will impose no

heavier burden on the Department than the construction of the Government.

The stock of the company, issued in 1912, was fully paid for, either by the tangible assets including the ore lands at their increased value, or the certificates of the old common stock. In either case tangible property was paid in for shares with an actual cash value within § 207 (a) (2) equal to $19,830,800,—and the company is accordingly entitled to include the full amount in its invested capital. *Williams* v. *Western Union Telegraph Co.*, 93 N. Y. 162, 190. In its essence the transaction in 1912 amounted to this: The shareholders surrendered all their old shares and thereupon, being in effect the owners of all the assets, "paid in" those assets to the corporation in exchange for the new stock issue.

The construction placed upon the act by the Department would create a wholly baseless and arbitrary discrimination amounting to a deprivation of property without due process of law. Such a construction is to be avoided if the act is to be constitutional.

This court has said that if there were arbitrary confiscation in a taxing law of Congress there would be a want of due process. *Knowlton* v. *Moore*, 178 U. S. 41, 77; *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 24, 25. See also, *Wagner* v. *Baltimore*, 239 U. S. 207; *Twining* v. *New Jersey*, 211 U. S. 78; *McCray* v. *United States*, 195 U. S. 27; *Flint* v. *Stone Tracy Co.*, 220 U. S. 107; *Billings* v. *United States*, 232 U. S. 261. The foregoing cases make it clear that a taxing law which imposes a tax based on a wholly arbitrary classification is void within the Fifth Amendment. To be sure, in all the cases the court found that the classification was not of that character. But the discussion in all is based on the implied assumption that if the classification were of that arbitrary character the law would be invalid.

The due process clause in the Fifth Amendment means

the same thing as the due process clause in the Fourteenth Amendment. *Carroll* v. *Greenwich Insurance Co.*, 199 U. S. 401, 410; *Tonawanda* v. *Lyon*, 181 U. S. 389, 392, 393; *French* v. *Barber Asphalt Paving Co.*, 181 U. S. 324; *Flint* v. *Stone Tracy Co.*, 220 U. S. 107; *Hibben* v. *Smith*, 191 U. S. 310, 325, 326.

In *Gast Realty Co.* v. *Schneider Granite Co.*, 240 U. S. 55, and in other cases in this court, tax laws of States have been held so arbitrary and baseless as to violate the Fourteenth Amendment. *Looney* v. *Crane Co.*, 245 U. S. 178; *International Paper Co.* v. *Massachusetts*, 246 U. S. 135; *Southern Ry. Co.* v. *Greene*, 216 U. S. 400.

The present law as construed by the Department is utterly arbitrary, and therefore invalid, because the tax depends largely upon the cost of the taxpayer's property so that two taxpayers who have the same income, and property of equal value, will pay wholly different taxes if the cost of the property is different.

The Solicitor General for the United States.

Mr. Frank Hagerman and *Mr. Massey Holmes*, by leave of court, filed a brief as *amici curiæ*.

Mr. Jesse Andrews, by leave of court, filed a brief as *amicus curiæ*.

Mr. William D. Guthrie, *Mr. Henry M. Ward*, *Mr. Henry F. Parmelee* and *Mr. Langdon P. Marvin*, by leave of court, filed a brief as *amici curiae*.

Mr. Clark J. Milliron, *Mr. James M. Proctor* and *Mr. Edward S. Brashears*, by leave of court, filed a brief as *amici curiæ*.

Mr. Clarence N. Goodwin, by leave of court, filed a brief as *amicus curiæ*.

Mr. Armwell L. Cooper, *Mr. Ellison A. Neel* and *Mr. John S. Wright*, by leave of court, filed a brief as *amici curiæ*.

Mr. Justice Pitney delivered the opinion of the court.

The Court of Claims dismissed appellant's petition which claimed a refund of $1,081,184.61, alleged to have been erroneously assessed and exacted as an "excess profits tax" under Title II of the Revenue Act of 1917 (Act of October 3, 1917, c. 63, 40 Stat. 300, 302, *et seq.*). The case involves the construction and application of those provisions by which the deduction from income, for the purposes of the tax, is measured by the "invested capital" of the taxpayer; and a question is raised as to the constitutionality of the act as construed and applied.

Title I of the act imposed "War Income Taxes" upon individuals and corporations in addition to those imposed by Act of September 8, 1916, c. 463, 39 Stat. 756. Title II provided for the levying of "War Excess Profits Taxes" upon corporations, partnerships, and individuals. As applied to domestic corporations, the scheme of this Title was that, after providing for a deduction from income (§ 203, p. 304) equal to the same percentage of the invested capital for the taxable year which the average amount of the annual net income of the trade or business during the prewar period (the years 1911, 1912, and 1913) was of the invested capital for that period, but not less than 7 nor more than 9 per cent., plus $3,000, it imposed (§ 201, p. 303), in addition to other taxes, a graduated tax upon the net income beyond the deduction, commencing with 20 per centum of such net income above the deduction but not above 15 per centum of the invested capital for the taxable year, and running as high as 60 per centum of the net income in excess of 33 per centum of such capital. It applied to "all trades or businesses," with exceptions not now material (p. 303).

What should be deemed "invested capital" was defined by § 207 (p. 306), which, so far as pertinent, is set forth in the margin.[1]

The case was decided upon a demurrer to the petition, in which the facts were stated as follows: Appellant is a domestic corporation and, prior to the year 1904, acquired ore lands for which it paid the sum of $190,000. Between that time and the year 1912 extensive explorations and developments were carried on (the cost of which is not stated), and it was proved that the lands contained large bodies of ore and had an actual cash value

[1] SEC. 207. That as used in this title, the term "invested capital" for any year means the average invested capital for the year, as defined and limited in this title, averaged monthly.

As used in this title "invested capital" does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title, nor money or other property borrowed, and means, subject to the above limitations:

(a) In the case of a corporation or partnership: (1) Actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year: *Provided*, That (a) the actual cash value of patents and copyrights paid in for stock or shares in such corporation or partnership, at the time of such payment, shall be included as invested capital, but not to exceed the par value of such stock or shares at the time of such payment, and (b) the good will, trade-marks, trade brands, the franchise of a corporation or partnership, or other intangible property, shall be included as invested capital if the corporation or partnership made payment bona fide therefor specifically as such in cash or tangible property, the value of such good will, trade-mark, trade brand, franchise, or intangible property, not to exceed the actual cash or actual cash value of the tangible property paid therefor at the time of such payment; but good

not less than $10,105,400; and at all times during the years 1912 to 1917, inclusive, their actual cash value was not less than the sum last mentioned. In the year 1912 the company increased the valuation of said lands upon its books by adding thereto the sum of $10,000,000, which it carried to surplus, and thereupon, in the same year, declared a stock dividend in the sum of $9,915,400, representing the increase in value of the ore lands. Theretofore appellant's capital stock had consisted of shares issued, all of one class, having a par value of $9,915,400. The declaration of the stock dividend was carried out by the surrender to the company of all the outstanding stock, and its cancellation, and the exchange of one share of new common and one share of new preferred stock for each share of the original stock.

In returning its annual net income for the year 1917 the company stated its invested capital to be $26,322,-904.14, in which was included the sum of $10,105,400 as representing the value of its ore lands. The Commissioner of Internal Revenue caused a reassessment to be made, based upon a reduction of the invested capital to $16,407,507.14; the difference ($9,915,400) being the increase in the value of the ore lands already mentioned. The result was an additional tax of $1,081,184.61, which, having been paid, was made the subject of a claim for refund; and this having been considered and rejected by

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will, trade-marks, trade brands, franchise of a corporation or partnership, or other intangible property, bona fide purchased, prior to March third, nineteen hundred and seventeen, for and with interests or shares in a partnership or for and with shares in the capital stock of a corporation (issued prior to March third, nineteen hundred and seventeen), in an amount not to exceed, on March third, nineteen hundred and seventeen, twenty per centum of the total interests or shares in the partnership or of the total shares of the capital stock of the corporation, shall be included in invested capital at a value not to exceed the actual cash value at the time of such purchase, and in case of issue of stock therefor not to exceed the par value of such stock; . . .

the Commissioner, there followed a suit in the Court of Claims, with the result already mentioned.

Appellant's contentions, in brief, are, first, that the increased value of the ore lands, placed upon the company's books in 1912, ought to be included in invested capital under § 207 (a) (3), as "paid in or earned surplus and undivided profits." Second, that within the meaning of clause (2), which provides that invested capital shall include "the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation," the stock of the company issued in 1912, consisting of $9,915,400 of preferred stock and an equal amount of common, was fully paid for: either (a) by the tangible assets, including the ore properties at their increased value, or (b) by the surrender of all the certificates representing the old common stock, which, it is said, had an actual cash value equal to double its par. And, third, that the construction put upon the act by the Treasury Department, based, as it is said, not upon value but upon the single feature of cost, disregarding the time of acquisition, would render the act unconstitutional as a deprivation of property without due process under the Fifth Amendment, because so arbitrary as to amount in effect to confiscation; and hence that this construction must be avoided.

Reading the entire language of § 207 in the light of the circumstances that surrounded the passage of the act, we think its meaning as to "invested capital" is entirely clear. The great war in Europe had been in progress since the year 1914, and the manufacture and export of war supplies and other material for the belligerent powers had stimulated many lines of trade and business in this country, resulting in large profits as compared with the period before the war, and as compared with ordinary returns upon the capital embarked. The United States had become directly involved in the conflict in the Spring

of 1917, necessitating heavy increases in taxation; at the same time manufactures and trade of every description were rendered even more active, and in certain lines more profitable, than before, so that the unusual gains derived therefrom formed a natural subject for special taxation.

On the eve of our entry, and in order to provide a "Special Preparedness Fund" for army, navy, and fortification purposes, an act (March 3, 1917, c. 159, 39 Stat. 1000) was passed, which, in Title II, provided for an excess profits tax on corporations and partnerships equal to 8 per centum of the amount by which their net income exceeded $5,000 plus 8 per centum of the "actual capital invested"; and, in § 202 (p. 1001), defined this term to mean "(1) actual cash paid in, (2) the actual cash value, at the time of payment, of assets other than cash paid in, and (3) paid in or earned surplus and undivided profits used or employed in the business," but not to include money or other property borrowed.

The Revenue Act of October 3, 1917, passed after we had become engaged in the war, took the place of the Act of March 3, and embodied a "War Excess Profits Tax," with higher percentages imposed upon the income in excess of deductions and a more particular definition of terms. A scrutiny of the particular provisions of § 207 shows that it was the dominant purpose of Congress to place the peculiar burden of this tax upon the income of trades and businesses exceeding what was deemed a normally reasonable return upon the capital actually embarked. But if such capital were to be computed according to appreciated market values based upon the estimates of interested parties (on whose returns perforce the Government must in great part rely), exaggerations would be at a premium, corrections difficult, and the tax easily evaded. Section 207 shows that Congress was fully alive to this and designedly adopted a term—"invested capital"—and a definition of it, that would

measurably guard against inflated valuations. The word "invested" in itself imports a restrictive qualification. When speaking of the capital of a business corporation or partnership, such as the act deals with, "to invest" imports a laying out of money, or money's worth, either by an individual in acquiring an interest in the concern with a view to obtaining income or profit from the conduct of its business, or by the concern itself in acquiring something of permanent use in the business; in either case involving a conversion of wealth from one form into another suitable for employment in the making of the hoped-for gains. See Webster's New Internat. Dict., "invest," 8; Century Dict., "invest," 7; Standard Dict., "invest," 1.

In order to adhere to this restricted meaning and avoid exaggerated valuations, the draftsman of the act resorted to the test of including nothing but money, or money's worth, actually contributed or converted in exchange for shares of the capital stock, or actually acquired through the business activities of the corporation or partnership (involving again a conversion) and coming in *ab extra*, by way of increase over the original capital stock. How consistently this was carried out becomes evident as the section is examined in detail. Cash paid in, and tangible property paid in other than cash, are confined to such as were contributed for stock or shares in the corporation or partnership; and the property is to be taken at its actual cash value "at the time of such payment"—distinctly negativing any allowance for appreciation in value. There is but a single exception: tangible property paid in prior to January 1, 1914, may be taken at its actual cash value on that date, but in no case exceeding the par value of the original stock or shares specifically issued for it; a restriction in itself requiring the valuation to be taken as of a date prior to the war period, and in no case to exceed the stock valuation placed upon it at the

time it was contributed. The provision of clause (3) that includes "paid in or earned surplus and undivided profits used or employed in the business" recognizes that in some cases contributions are received from stockholders in money or its equivalent for the specific purpose of creating an actual excess capital over and above the par value of the stock; and, in view of the context, surplus "earned" as well as that "paid in" excludes the idea of capitalizing (for the purposes of this tax) a mere appreciation of values over cost.

The same controlling thought is carried into the proviso, which relates to the valuation of patents, copyrights, trade-marks, good will, franchises, and similar intangible property. Every line shows evidence of a legislative purpose to confine the account to such items as were paid in for stock or shares, and to their values "at the time of such payment"; but, with regard to those *bona fide* purchased prior to March 3, 1917, there is a special provision, limiting the effect of any adjustments that might have been made in view of the provisions of the act of that date.

It is clear that clauses (1) and (2) refer to actual contributions of cash or of tangible property at its cash value contributed in exchange for stock or shares specifically issued for it; and that neither these clauses, nor clause (3) which relates to surplus, can be construed as including within the definition of invested capital any marking up of the valuation of assets upon the books to correspond with increase in market value, or any paper transaction by which new shares are issued in exchange for old ones in the same corporation, but which is not in substance and effect a new acquisition of capital property by the company.

It is clear enough that Congress adopted the basis of "invested capital" measured according to actual contributions made for stock or shares and actual accessions

in the way of surplus, valuing them according to actual and *bona fide* transactions and by valuations obtaining at the time of acquisition, not only in order to confine the capital, the income from which was to be in part exempted from the burden of this special tax, to something approximately representative of the risks accepted by the investors in embarking their means in the enterprise, but also in order to adopt tests that would enable returns to be more easily checked by examination of records, and make them less liable to inflation than if a more liberal meaning of "capital and surplus" had been adopted; thus avoiding the necessity of employing a special corps of valuation experts to grapple with the many difficult problems that would have ensued had general market values been adopted as the criteria.

In view of the special language employed in § 207, obviously for the purpose of avoiding appreciated valuations of assets over and above cost, the argument that such value is as real as cost value, and that in the terminology of corporation and partnership accounting "capital and surplus" means merely the excess of all assets at actual values over outstanding liabilities, and "surplus" means the intrinsic value of all assets over and above outstanding liabilities plus par of the stock, is beside the mark. Nor has the distinction between capital and income, discussed in *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 187; *Hays* v. *Gauley Mountain Coal Co.*, 247 U. S. 189, 193; and *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 334–335, any proper bearing upon the questions here presented.

Upon the strength of an administrative interpretation contained in a Treasury Regulation pertaining to the Revenue Act of 1917, under which "stocks" were to be regarded as tangible property when paid in for stock or shares of a corporation, it is insisted that appellant's stock dividend distribution of 1912 ought to be treated

as paid for in tangible property, the old stock surrendered being regarded as tangible for the purpose. But that distribution, in substance and effect, was an internal transaction, in which the company received nothing from the stockholders any more than they received anything from it (see *Eisner* v. *Macomber*, 252 U. S. 189, 210–211); and the old shares cannot be regarded as having been "paid in for" the new ones within the meaning of § 207 (a) (2), even were they "stocks" within the meaning of that Regulation, which is doubtful.

It is said that the admitted increase in the value of appellant's ore lands is properly to be characterized as earned surplus, because it was the result of extensive exploration and development work. We assume that a proper sum, not exceeding the cost of the work, might have been added to earned surplus on that account; but none such was stated in appellant's petition, nor, so far as appears, in its return of income. In the absence of such a showing it was not improper to attribute the entire $9,915,400, added to the book value of the ore property in the year 1912, to a mere appreciation in the value of the property; in short, to what is commonly known as the "unearned increment," not properly "earned surplus" within the meaning of the statute.

The foregoing considerations dispose of the contention that either the increased value of appellant's ore lands, or the surrender of the old stock in exchange for the new issues based upon that value, can be regarded as "tangible property paid in other than cash, for stock or shares in such corporation" within the meaning of § 207 (a) (2); and of the further contention that such increased value can properly be regarded as "paid in or earned surplus and undivided profits" under § 207 (a) (3).

It is urged that this construction, defining invested capital according to the original cost of the property instead of its present value, has the effect of rendering the

act "glaringly unequal" and of doubtful constitutionality; the insistence being that, so construed, it operates to produce baseless and arbitrary discriminations, to the extent of rendering the tax invalid under the due process of law clause of the Fifth Amendment. Reference is made to cases decided under the equal protection clause of the Fourteenth Amendment (*Southern Ry. Co.* v. *Greene*, 216 U. S. 400, 418; *Gast Realty Co.* v. *Schneider Granite Co.*, 240 U. S. 55); but clearly they are not in point. The Fifth Amendment has no equal protection clause; and the only rule of uniformity prescribed with respect to duties, imposts, and excises laid by Congress is the territorial uniformity required by Art. I, § 8. *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, 557; *Knowlton* v. *Moore*, 178 U. S. 41, 98, 106; *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, 150; *Billings* v. *United States*, 232 U. S. 261, 282; *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1, 24. That the statute under consideration operates with territorial uniformity is obvious and not questioned.

Appellant cites *Looney* v. *Crane Co.*, 245 U. S. 178, 188, and *International Paper Co.* v. *Massachusetts*, 246 U. S. 135, 145, but these cases also are inapplicable, being based upon the due process clause of the Fourteenth Amendment, with which state taxing laws were held in conflict because they had the effect of imposing taxes on the property of foreign corporations located and used beyond the jurisdiction of the taxing State. There is no such infirmity here.

Nor can we regard the act—in basing "invested capital" upon actual costs to the exclusion of higher estimated values—as productive of arbitrary discriminations raising a doubt about its constitutionality under the due process clause of the Fifth Amendment. The difficulty of adjusting any system of taxation so as to render it precisely equal in its bearing is proverbial, and such nicety is not even required of the States under the equal protection

clause, much less of Congress under the more general requirement of due process of law in taxation. Of course it will be understood that Congress has very ample authority to adjust its income taxes according to its discretion, within the bounds of geographical uniformity. Courts have no authority to pass upon the propriety of its measures; and we deal with the present criticism only for the purpose of refuting the contention, strongly urged, that the tax is so wholly arbitrary as to amount to confiscation.

The act treats all corporations and partnerships alike, so far as they are similarly circumstanced. As to one and all, Congress adjusted this tax, generally speaking, on the basis of excluding from its operation income to the extent of a specified percentage (7 to 9 per cent.) of the capital employed, but upon condition that such capital be valued according to what actually was embarked at the outset or added thereafter, disregarding any appreciation in values. If in its application the tax in particular instances may seem to bear upon one corporation more than upon another, this is due to differences in their circumstances, not to any uncertainty or want of generality in the tests applied.

Minor distinctions—such as those turning upon the particular dates of January 1, 1914, and March 3, 1917—are easily explained, as we have seen. The principal line of demarcation—that based upon actual costs, excluding estimated appreciation—finds reasonable support upon grounds of both theory and practice, in addition to the important consideration of convenience in administration, already adverted to. There is a logical incongruity in entering upon the books of a corporation as the capital value of property acquired for permanent employment in its business and still retained for that purpose, a sum corresponding not to its cost but to what probably might be realized by sale in the market. It is not merely that

the market value has not been realized or tested by sale made, but that sale cannot be made without abandoning the very purpose for which the property is held, involving a withdrawal from business so far as that particular property is concerned. Whether in a given case property should be carried in the capital account at market value rather than at cost may be a matter of judgment, depending upon special circumstances and the local law. But certainly Congress, in seeking a general rule, reasonably might adopt the cost basis, resting upon experience rather than anticipation.

In organizing corporations, it is not unusual to issue different classes of securities, with various priorities as between themselves, to represent different kinds of contribution to capital. In exchange for cash, bonds may be issued; for fixed properties, like plant and equipment, preferred stock may be given; while more speculative values, like good-will or patent rights, may be represented by common stock. In the present case, for instance, when appellant took the estimated increase in value of its ore lands as a basis for increased capitalization, it issued preferred stock to the amount of the former total, carrying those lands at cost, and issued a like amount of common stock to represent the appreciation in their market value. It does not appear that in form the new issues were thus allocated; but at least there was a recognition of a higher claim in favor of one part of the book capital than of the other. Upon like grounds, it was not unreasonable for Congress, in adjusting the "excess profits tax," to accord preferential treatment to capital representing actual investments, as compared with capital representing higher valuations based upon estimates, however confident and reliable, of what probably could be realized were the property sold instead of retained.

From every point of view, the tax in question must be sustained. We intimate no opinion upon the effect of

the act with respect to deductions from cost values of capital assets because of depreciation or the like; no question of that kind being here involved.

Judgment affirmed.

MR. JUSTICE MCREYNOLDS concurs in the result.